Department of the Treasury

PRESS RELEASES

The following numbers were not used:
584
602
619

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 16, 2003
JS-566

Statement by Treasury Secretary Snow and Commerce Secretary Evans on the Internet Tax Moratorium

Treasury Secretary John Snow and Commerce Secretary Don Evans made the following statement today after the House Judiciary Committee approved legislation to extend the Internet Tax moratorium. Earlier this year, Secretary Snow and Secretary Evans sent a letter to Congress urging them to act quickly to extend the Internet Tax moratorium.

"The Internet is an innovative force that opens vast potential economic and social benefits of e-commence and enables such applications as distance learning, telemedicine,
e-business, e-government and precision farming. Government must not slow the rollout of Internet services by creating administrative barriers or imposing new access taxes. Nor should government stifle e-commerce through multiple or discriminatory taxes.

Today's Committee vote is welcome news and will help ensure that the full Congress will have time to pass, and the President to sign, legislation extending the moratorium before it expires on November 1, 2003."

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 16, 2003
JS-567

Treasury and IRS Propose Comprehensive Rules for 401(k) Plans

Today, the Treasury Department and the IRS proposed regulations governing 401 (k) plans. The 401(k) plan is the most common type of employer-sponsored retirement plan, providing retirement income security for millions of American workers and their families. The regulations apply to plans that permit employees to make pre-tax contributions and to plans that have employer matching contributions or employee after-tax contributions.
The existing regulations covering these plans were last updated in 1994.

Since then, there have been significant statutory changes. The new proposed regulations will replace the current regulations, incorporate the guidance issued since 1994, and address open issues.

"The proposed rules are the result of years of gathering useful and much appreciated insights from the retirement plan community," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "Our goal with the proposed rules is to put all the rules in one place and resolve a number of open matters. Ending uncertainty will make it easier for employers to sponsor plans to help employees save for their retirement and will assist administrators who are charged with ensuring that their plans adhere to all the Internal Revenue Code requirements that apply to employer plans."

When finalized, the proposed regulations will update and simplify many of the current rules for 401(k) plans. In addition, the new regulations will strengthen the nondiscrimination rules that ensure benefits for rank-and-file employees. The proposed regulations will require certain employer contributions to be spread over a large group of rank-and-file employees before they can boost the ability of high-paid employees to defer income under the plan.

The proposed regulations will be effective for plan years that begin 12 months after they are issued in final form.

Related Documents:

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-108639-99]

RINs 1545-AX26, 1545-AX43

Retirement plans; Cash or deferred arrangements under section 401(k) and matching contributions or employee contributions under section 401(m) Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that would provide guidance for certain retirement plans containing cash or deferred arrangements under section 401(k) and providing for matching contributions or employee contributions under section 401(m). These regulations affect sponsors of plans that contain cash or deferred arrangements or provide for employee or matching contributions, and participants in these plans. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for November 12, 2003, must be received by October 22, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-108639-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-108639-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS Internet site at: www.irs.gov/regs. The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, R. Lisa Mojiri-Azad or John T. Ricotta at (202) 622-6060 (not a toll-free number); concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, Lanita Van Dyke, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP Washington, DC 20224. Comments on the collections of information should be received by Septermber 15, 2003. Comments are specifically requested concerning:

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

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

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

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

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

The collections of information in these proposed regulations are contained in §§1.401(k)-1(d)(3)(iii)(C), 1.401(k)-2(b)(3), 1.401(k)-3(d), 1.401(k)-3(f), 1.401(k)-3(g), 1.401(k)-4(d)(3), 1.401(m)-3(e), 1.401(m)-3(g) and 1.401(m)-3(h). The information required by §§1.401(k)-3(d), 1.401(k)-3(f), 1.401(k)-3(g), 1.401(m)-3(e), 1.401(m)-3(g) and 1.401(m)-3(h) is required by the IRS to comply with the requirements of sections 401(k)(12)(D) and 401(m)(11)(A)(ii) regarding notices that must be provided to eligible participants to apprize them of their rights and obligations under certain plans. This information will be used by participants to determine whether to participate in the plan, and by the IRS to confirm that the plan complies with applicable qualification requirements to avoid adverse tax consequences. The information required by §1.401(k)-4(d)(3) is required by the IRS to comply with the requirements of section

401(k)(11)(B)(iii)(II) regarding notices that must be provided to eligible participants to apprize them of their rights and obligations under certain plans. This information will be used by participants to determine whether to participate in the plan, and by the IRS to confirm that the plan complies with applicable qualification requirements to avoid adverse tax consequences. The information required by §1.401(k)-2(b)(3) will be used by employees to file their income tax returns and by the IRS to assess the correct amount of tax. The information provided under §1.40(k)-1(d)(3)(iii)(C) will be used by employers in determining whether to make hardship distributions to participants. The collections of information are mandatory. The respondents are businesses or other for-profit institutions, and nonprofit institutions.

Estimated total annual reporting burden: 26,500 hours.

The estimated annual burden per respondent is 1 hour, 10 minutes.

Estimated number of respondents: 22,500.

The estimated annual frequency of responses: On occasion.

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

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

Background

This document contains proposed new comprehensive regulations setting forth the requirements (including the nondiscrimination requirements) for cash or deferred arrangements under section 401(k) and for matching contributions and employee contributions under section 401(m) of the Internal Revenue Code (Code).

Comprehensive final regulations under sections 401(k) and 401(m) of the Code were last published in the **Federal Register** in TD 8357 (published August 9, 1991) and TD 8376 (published December 2, 1991) and amended by TD 8581 published on December 22, 1994. Since 1994, many significant changes have been made to sections 401(k) and 401(m) by the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755) (SBJPA), the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788) (TRA '97), and the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (115 Stat. 38) (EGTRRA).

The most substantial changes to the section 401(k) and section 401(m) provisions were made to the methodology for testing the amount of elective contributions, matching contributions, and employee contributions for nondiscrimination. Section 401(a)(4) prohibits discrimination in contribution or benefits in favor of highly compensated employees (within the meaning of section 414(q)) (HCEs). Section 401(k) provides a special nondiscrimination test for elective contributions under a cash or deferred arrangement that is part of a profit-sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan, called the actual deferral percentage (ADP) test. Section 401(m) provides a parallel test for matching contributions and employee contributions under a defined contribution plan, called the actual contribution percentage (ACP) test. These special nondiscrimination standards are provided in recognition of the fact that the amount of elective contributions and employee contributions (and corresponding matching contributions) is determined by the employee's utilization of the contribution opportunity offered under the plan. This is in contrast to the situation in other defined contribution plans where the amount of contributions is determined by the amount the employer decides to contribute.

Sections 401(k) and 401(m) provide alternative methods for satisfying the applicable nondiscrimination rules: a mathematical comparison and a number of design-based methods. The inherent variation in the amount of contributions among employees noted above, and the fact that the economic situation of HCEs may make them more likely to make elective or employee contributions, means that the usual nondiscrimination test under section 401(a)(4) -- under which for each HCE with a contribution level there must be a specified number of nonhighly compensated employees (NHCEs) with equal or greater contributions -- is not appropriate. Instead, average rates of contribution are used in the ADP and ACP tests (with a built-in differential permitted for HCEs) and minimum standards for nonelective or matching contributions are provided in the design-based alternatives.

Prior to the enactment of SBJPA, sections 401(k) and 401(m) provided only for mathematical comparison. Specifically, the ADP and ACP tests compare the average of the rates of contributions of the HCEs to the average of the rates of contributions of the NHCEs. For this purpose, the rate of contributions for an employee is the amount of contributions for an employee divided by the employee's compensation for the plan year. These tests are satisfied if the average rate of HCE contributions does not exceed 1.25 times the average rate of contributions of the NHCEs. Alternatively, these tests are satisfied if the average rate of HCE contributions does not exceed the average rate of contributions of the NHCEs by more than 2 percentage points and is no more than 2 times the average rate of contributions of the NHCEs. To the extent that these tests are not satisfied, the statute provides for correction through distribution to HCEs (or forfeiture of nonvested matching contributions) or, to the extent provided in regulations, recharacterization of elective contributions as after-tax contributions. In addition, to the extent provided in regulations, nonelective contributions can be made to NHCEs and elective contributions and certain matching contributions can be moved between the ADP and ACP tests, in order the reduce the discrepancy between the average rates of contribution for the HCEs and the NHCEs.

SBJPA added design-based alternative methods of satisfying the ADP and ACP tests. Under these methods, if a plan meets certain contribution and notice requirements, the plan is deemed to satisfy the nondiscrimination rules without regard to actual utilization of the contribution opportunity offered under the plan. These regulations reflect this change and the other changes that were made to sections 401(k) and 401(m) under SBJPA, TRA '97 and EGTRRA since the issuance of final regulations under those sections.

SBJPA made the following significant changes affecting section 401(k) and section 401(m) plans:

- The ADP test and ACP test were amended to allow the use of prior year data for NHCEs.
- The method of distributing to correct failures of the ADP test or ACP test was changed to require distribution to the HCEs with the highest contributions.

- Tax-exempt organizations and Indian tribal governments are permitted to maintain section 401(k) plans.

- A safe harbor alternative to the ADP test and ACP test was introduced in order to provide a design-based method to satisfy the nondiscrimination tests.

- The SIMPLE 401(k) plan (an alternative design-based method to satisfy the nondiscrimination tests for small employers that corresponds to the provisions of section 408(p) for SIMPLE IRA plans by providing for smaller contributions) was added.

- A special testing option was provided for plans that permit participation before employees meet the minimum age and service requirements, in order to encourage employers to permit employees to start participating sooner.

TRA '97 made the following significant changes affecting section 401(k) and section 401(m) plans:

- State and local governmental plans are treated as automatically satisfying the ADP and ACP tests.

- Matching contributions for self-employed individuals are no longer treated as elective contributions.

EGTRRA made the following significant changes affecting section 401(k) and section 401(m) plans:

- Catch-up contributions were added to provide for additional elective contributions for participants age 50 or older.

- The Secretary was directed to change the section 401(k) regulations to shorten the period of time that an employee is stopped from making elective contributions under the safe harbor rules for hardship distributions.

- Beginning in 2006, section 401(k) plans will be permitted to allow employees to designate their elective contributions as "Roth contributions" that will be subject to taxation under the rules applicable to Roth IRAs under section 408A.

- Section 401(k) plans using the design-based safe harbor and providing no additional contributions in a year are exempted from the top-heavy rules of section 416.

- Distributions from section 401(k) plans are permitted upon "severance from employment" rather than "separation from service."
- The multiple use test specified in section 401(m)(9) is repealed.
- Faster vesting is required for matching contributions
- Matching contributions are taken into account in satisfying the top-heavy requirements of section 416.

In addition, since publication of the final regulations, a number of items of guidance affecting section 401(k) and section 401(m) plans addressing these statutory changes and other items have been issued by the IRS, including:

- Notice 97-2 (1997-1 C.B. 348) provided initial guidance on prior year ADP and ACP testing and guidance on correction of excess contributions and excess aggregate contributions, including distribution to the HCEs with the highest contributions.
- Rev. Proc. 97-9 (1997-1 C.B. 624) provided model amendments for SIMPLE 401(k) plans.
- Notice 98-1 (1998-1 C.B. 327) provided additional guidance on prior year testing issues.
- Notice 98-52 (1998-2 C.B. 632) and Notice 2000-3 (2000-1 C.B. 413) provided guidance on safe harbor section 401(k) plans.
- Rev. Rul. 2000-8 (2000-1 C.B. 617) addressed the use of automatic enrollment features in section 401(k) plans.
- Notice 2001-56 (2001-2 C.B. 277) and Notice 2002-4 (2002-2 I.R.B. 298) provided initial guidance related to the changes made by EGTRRA.

These items of guidance are incorporated into these proposed regulations with some modifications and the proposed regulations have been reorganized as indicated in the tables of contents at proposed §§1.401(k)-0 and 1.401(m)-0. Treasury and the IRS believe that a single restatement of the section 401(k) and section 401(m) rules serves the interests of plan sponsors, third-party administrators, plan participants, and plan beneficiaries.

The process of reviewing and integrating all existing administrative guidance under sections 401(k) and 401(m) has led Treasury and the IRS to reconsider certain rules and to propose certain changes in those rules. To the extent practicable, this preamble identifies the substantive changes and explains the underlying analysis. In many cases, the changes will clarify or simplify existing guidance and will reduce plan administrative burdens.

Treasury and the IRS appreciate the fact that plan sponsors and third-party administrators have developed systems and practices in the application of existing administrative guidance to the design and operation of section 401(k) and section 401(m) plans. In many cases, the details of these systems and practices have been determined through a plan sponsor's or administrator's interpretation of specific terms in existing guidance or, where no guidance has been provided, through a plan sponsor's or administrator's best legal and practical judgment. As a result, these systems and practices may differ from administrator to administrator, from sponsor to sponsor, or from plan to plan.

Treasury and the IRS also recognize that certain of the substantive changes in these proposed regulations will require changes in plan design or plan operation. However, the proposed regulations are not otherwise intended to require significant changes in plan systems and practices that were developed under existing guidance and that conform to the requirements of sections 401(k) and 401(m). Therefore, Treasury and the IRS specifically request that plan sponsors and third-party administrators comment on points where the proposed regulations might have the unintended effect of requiring a change to plan systems or practices so that Treasury and the IRS can further evaluate whether such a change is in fact appropriate or whether Treasury and the IRS should instead make an adjustment in the final regulations.

Explanation of Provisions

1. <u>Rules Applicable to All Cash or Deferred Arrangements</u>

Section 401(k)(1) provides that a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan will not fail to qualify under section 401(a) merely because it contains a qualified cash or deferred arrangement. Section 1.401(k)-1 would set forth the general definition of a cash or deferred arrangement (CODA), the additional requirements that a CODA must satisfy in order to be a qualified CODA, and the treatment of contributions made under a qualified or nonqualified CODA.

As under the existing final regulations, a CODA is defined as an arrangement under which employees can make a cash or deferred election with respect to contributions to, or accruals or benefits under, a plan intended to satisfy the requirements of section 401(a). A cash or deferred election is any direct or indirect election by an employee (or modification of an earlier election) to have the employer either: 1) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available; or 2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election can include a salary reduction agreement, but the specific reference to a salary reduction agreement has been eliminated as unnecessary. In addition, the proposed regulations would incorporate prior guidance on automatic enrollment, and thus would reflect the fact that a CODA can specify that the default that applies in the absence of an affirmative election by an employee can be a contribution to a trust, as described in Rev. Rul. 2000-8.[1]

The proposed regulations would continue to provide that the definition of a CODA excludes contributions that are treated as after-tax employee contributions at the time of the contribution and contributions made pursuant to certain one-time irrevocable elections, but would also specify that a CODA does not include an arrangement under which dividends paid to an ESOP are either distributed to a participant or reinvested in employer securities in the ESOP pursuant to an election by the participant or beneficiary

[1] The Department of Labor has advised Treasury and the IRS that, under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), fiduciaries of a plan must ensure that the plan is administered prudently and solely in the interest of plan participants and beneficiaries. While ERISA section 404(c) may serve to relieve certain fiduciaries from liability when participants or beneficiaries exercise control over the assets in their individual accounts, the Department of Labor has taken the position that a participant or beneficiary will not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary. See 29 CFR 2550.404c-1 and 57 FR 46924.

under section 404(k)(2)(A)(iii) as added by EGTRRA.

The proposed regulations would also specify that a contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made. Thus, a contribution made in anticipation of an employee's election is not treated as an elective contribution. Similarly, the regulations would provide that a contribution is made pursuant to a cash or deferred election only if the contribution is made after the employee's performance of services which relate to the compensation that, but for the election, would be paid to the employee. (If the payment of compensation would have preceded the performance of services, a contribution made no earlier than the date the compensation would have been paid, but for the election, is also treated as made pursuant to a cash or deferred election). Accordingly, amounts contributed in anticipation of future performance of services generally would not be treated as elective contributions under section 401(k). These restrictions on the timing of contributions are consistent with the fundamental premise of elective contributions, that these are contributions that are paid to the plan as a result of an employee election not to receive those amounts in cash. Moreover, ensuring that contributions are made after the employee's election furthers plan administrability.

The deductibility of these prefunded elective contributions (as well as prefunded matching contributions) for the taxable year in which the contribution was made was addressed in Notice 2002-48 (2002-29 I.R.B.139). In that notice, the IRS indicated that it was reviewing issues other than the deductibility of prefunded contributions but, pending additional guidance, would not challenge the deductibility of the contributions provided actual payment is made during the taxable year for which the deduction is claimed and the amount deducted does not exceed the applicable limit under section 404(a)(3)(A)(i). After considering this issue, the IRS and Treasury have concluded that the prefunding of elective contributions and matching contributions is inconsistent with sections 401(k) and 401(m). Thus, under these proposed regulations, an employer would not be able to prefund elective contributions to accelerate the deduction for elective contributions. Once these regulations are finalized, employer contributions made under the facts in Notice 2002-48 would no longer be permitted to be taken into account under the ADP test or the ACP test and would not satisfy any plan requirement to provide elective contributions or matching contributions.

2. Qualified CODAs

A. General rules relating to qualified CODAs

Elective contributions under a qualified CODA are treated as employer contributions and generally are not included in the employee's gross income at the time the cash would have been received (but for the cash or deferred election), or at the time contributed to the plan. Elective contributions under a qualified CODA are included in the employee's gross income however, if the contributions are in excess of the section 402(g) limit for a year, are designated Roth contributions (under section 402A, effective for tax years beginning after December 31, 2005) or are recharacterized as after-tax contributions as part of a correction of an ADP test failure.

A CODA is not qualified unless it is part of a profit sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan and provides for an election between contributions to the plan or payments directly in cash. In addition, a CODA is not qualified unless it meets the following requirements: 1) the elective contributions under the CODA satisfy either the ADP test set forth in section 401(k)(3) or one of the design-based alternatives in section 401(k)(11) or (12); 2) elective contributions under the CODA are nonforfeitable at all times; 3) elective contributions are distributable only on the occurrence of certain events, including attainment of age 59½, hardship, death, disability, severance from employment, or termination of the plan; 4) the group of employees eligible to participate in the CODA satisfies the coverage requirements of section 410(b)(1); 5) no other benefit (other than matching contributions or another specified benefit) is conditioned, directly or indirectly, upon the employee's making or not making elective contributions under the CODA; and 6) no more than 1 year of service is required for eligibility to elect to make a cash or deferred election.

Subject to certain exceptions, State and local governmental plans are not allowed to include a qualified CODA. Plans sponsored by Indian tribal governments and rural cooperatives are allowed to include a qualified CODA.

B. Nondiscrimination rules applicable to CODAs

As under the existing regulations, the proposed regulations would provide that the special nondiscrimination standards set forth in section 401(k) are the exclusive means by which a qualified CODA can satisfy the nondiscrimination in amount of contribution requirement of section 401(a)(4). These special nondiscrimination standards now include: the ADP test, the ADP safe harbor and the SIMPLE 401(k) plan. Pursuant to section 401(k)(3)(G), a State or local governmental plan is deemed to satisfy the ADP test.

In addition, as under existing regulations, the plan must satisfy the requirements of §1.401(a)(4)-4 with respect to the nondiscriminatory availability of benefits, rights and features, including the availability of each level of elective contributions, matching contributions, and after-tax employee contributions. The provisions of the existing regulations related to compliance with sections 410(b) and 401(a)(4) would be revised to clarify the relationship of the rules under sections 410(b) and 401(a)(4) to the requirements for a qualified CODA and to remove redundant provisions. Except as provided below, however, these rules are substantively unchanged.

These proposed regulations are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of section 401(k). Further, these nondiscrimination requirements are part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of section 401(k) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of section 401(k), if a principal purpose of the changes was to achieve such a result.

C. Aggregation and disaggregation of plans

The proposed regulations would consolidate the rules in the existing regulations regarding identification of CODAs and plans for purposes of demonstrating compliance with the requirements of section 401(k). As under the existing regulations, all CODAs included in a plan are treated as a single CODA for purposes of applying the nondiscrimination tests. For this purpose, a plan is generally defined by reference to §1.410(b)-7(a) and (b) after application of the mandatory disaggregation rules of §1.410(b)-7(c) (other than the mandatory disaggregation of section 401(k) and section 401(m) plans) and permissive aggregation rules of §1.410(b)-7(d), as modified under these regulations. For example, if a plan covers collectively bargained employees and noncollectively bargained employees, the elective contributions for the separate groups of employees must be subject to separate nondiscrimination tests under section 401(k). The proposed regulations would also retain the special rules in the existing regulations that permit the aggregation of certain employees in different collective bargaining units and the prohibition on restructuring under §1.401(a)(4)-9(c).

The proposed regulations would change the treatment of a CODA under a plan which includes an ESOP. Section 1.410(b)-7(c)(2) provides that the portion of a plan that is an ESOP and the portion that is not an ESOP are treated as separate plans for purposes of section 410(b) (except as provided in §54.4975-11(e)). Accordingly, under the existing regulations, such a plan must apply two separate nondiscrimination tests: one for elective contributions going into the ESOP portion (and invested in employer stock) and one for elective contributions going in the non-ESOP portion of the plan. The additional testing results in increased expense and administrative difficulty for the plan and creates the possibility that the ESOP portion or the non-ESOP portion may fail the ADP test or ACP test because HCEs may be more or less likely to invest in employer securities than NHCEs.

Since the issuance of the existing regulations, the use of an ESOP as the employer stock fund in a section 401(k) plan has become much more widespread. In light of this development, the proposed regulations would eliminate disaggregation of the ESOP and non-ESOP portions of a single section 414(l) plan for purposes of ADP testing. The same rule would apply for ACP testing under section 401(m). In addition, the proposed regulations would provide that, for purposes of applying the ADP test or the ACP test, an employer could permissively aggregate two section 414(l) plans, one that is an ESOP and one that is not.

However, the exception to mandatory disaggregation of ESOPs from non-ESOPs set forth in these proposed regulations would not apply for purposes of satisfying section 410(b). Accordingly, the group of eligible employees under the ESOP and non-ESOP portions of the plan must still separately satisfy the requirements of sections 401(a)(4) and 410(b).

The proposed regulations would also provide that a single testing method must apply to all CODAs under a plan. This has the effect of restricting an employer's ability to aggregate section 414(l) plans for purposes of section 410(b), if those plans apply inconsistent testing methods. For example, a plan that applies the ADP test of section 401(k)(3) may not be aggregated with a plan that uses the ADP safe harbor of section 401(k)(12) for purposes of section 410(b).

D. Restrictions on withdrawals

As discussed above, a qualified CODA must provide that elective contributions may only be distributed after certain events, including hardship and severance from employment. EGTRRA amended section 401(k)(2)(B)(i)(I) by replacing "separation from service" with "severance from employment." This change eliminated the "same desk rule" as a standard for distributions under section 401(k) plans.

In addition, EGTRRA amended Code section 401(k)(10) by deleting disposition by a corporation of substantially all of the assets of a trade or business and disposition of a corporation's interest in a subsidiary, leaving termination of the plan as the only distributable event described in section 401(k)(10). Finally, EGTRRA directs the Secretary of the Treasury to revise the regulations relating to distributions under section 401(k)(2)(B)(i)(IV) to provide that the period during which an employee is prohibited from making elective and employee contributions following a hardship distribution is 6 months (instead of 12 months as required under §1.401(k)-1(d)(2)(iv)(B)(*4*) of the existing regulations).[2]

Notice 2001-56 and Notice 2002-4 provided guidance on these EGTRRA changes to the distribution rules for elective contributions. That guidance is incorporated in these proposed regulations. In connection with the change to severance from employment, comments are requested on whether a change in status from employee to leased employee described in section 414(n) should be treated as a severance from employment that would permit a distribution to be made. In addition, the proposed

---

[2] Under section 402(c), as amended by the IRS Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685), and EGTRRA, a hardship distribution is not an eligible rollover distribution. While the change affects distributions from a section 401(k) plan, there is no specific reference to the change in these proposed regulations because these regulations are under sections 401(k) and 401(m).

regulations do not include reference to “retirement” (included in the existing regulation) as an event allowing distribution because retirement is not listed in the statute, and is subsumed by severance from employment.

In addition to the statutory changes, the rules relating to hardship distributions have been reorganized in order to clarify certain ambiguities, including the relationship between the generally applicable rules, employee representations, and the safe harbors provided under the existing regulations. The existing regulations set forth two basic requirements (i.e., the employee has an immediate and heavy financial need and the distribution is necessary to satisfy that need) followed by safe harbor provisions. The proposed regulations would retain those basic requirements, but would clarify that each safe harbor is separately applicable to each basic requirement. In addition, the proposed regulations would provide that an employee representation used for purposes of determining that a distribution is necessary to satisfy an immediate and heavy financial need must provide that the need cannot reasonably be relieved by any available distribution or nontaxable plan loan (even if the distribution or loan would not be sufficient to satisfy the financial need), but need not provide that a loan from a commercial source will be taken if no such loan in an amount sufficient to satisfy the need is available on reasonable commercial terms.

The proposed regulations would also modify the existing regulations to add other types of defined contribution plans to the list of plans that an employer may maintain after the termination of the plan that contains the qualified CODA while still providing for distribution of elective contributions upon plan termination. The list of such plans has been expanded to include not only an ESOP and a SEP, but also a SIMPLE IRA plan, a plan or contract that satisfies section 403(b) and a section 457 plan.

Finally, under the existing regulations, a plan that receives a plan-to-plan transfer that includes elective contributions, QNECs, or QMACs, must provide that the restrictions on withdrawals continue after the transfer. These proposed regulations would also make explicit a requirement that the transferor plan will fail to comply with the restrictions on withdrawals if it transfers elective contributions, QNECs, or QMACs to a plan that does not provide for these restrictions. However, a transferor plan will not fail to comply with this requirement if it reasonably concludes that the transferee plan provides for restrictions on withdrawals. What constitutes a basis for a reasonable conclusion would be comparable to the rules related to acceptance of rollover distributions. See §1.401(a)(31)-1, A-14.

E. Other rules for qualified CODAs

The proposed regulations would generally retain the additional requirements set forth in the existing regulations that a CODA must satisfy in order to be qualified, with some modifications. First, in order to be a qualified CODA the arrangement must provide an employee with an effective opportunity to elect to receive the amount in cash no less than once during the plan year. Under the proposed regulations, whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time before the cash is currently available during which an election may be made, and any other conditions on elections.

The proposed regulations would also provide that a plan must provide for satisfaction of one of the specific nondiscrimination alternatives described in section

401(k). As with the existing regulations, the plan may accomplish this by incorporating by reference the ADP test of section 401(k)(3) and the regulations under proposed §1.401(k)-2, if that is the nondiscrimination alternative being used. If, with respect to the nondiscrimination alternative being used there are optional choices, the plan must provide which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3) must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the ADP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. The safe harbors are intended to provide employees with a minimum threshold in benefits in exchange for easier compliance for the plan sponsor. It would be inconsistent with this approach to providing benefits to allow an employer to deliver smaller benefits to NHCEs and revert to testing.

The proposed regulations would retain the existing rules relating to the section 401(k)(4)(A) prohibition on having benefits (other than a match) contingent on making or not making an elective contribution. However, the proposed regulations would specify that, in the case of a benefit that requires an amount to be withheld from an employee's pay, an employer is not violating the section 401(k)(4)(A) contingent benefit rule merely because the CODA restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes). In addition, these proposed regulations also reflect the amendment to section 416(c)(2)(A) under which matching contributions can be taken into account for purposes of satisfying the top-heavy minimum contribution requirement without violating the prohibition on making benefits contingent on making or not making elective contributions.

To reflect the amendment of section 401(k)(4)(B) by SBJPA to allow tax exempt organizations to maintain section 401(k) plans, the proposed regulations would also eliminate the provision prohibiting a tax-exempt employer from adopting a section 401(k) plan.

As under the existing final regulations, these proposed regulations would provide that a partnership is permitted to maintain a CODA, and individual partners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to common-law employees. This rule has been extended to sole proprietors. The provisions of these regulations also reflect the enactment of section 402(g)(8) (initially section 402(g)(9) as enacted by TRA '97) providing that matching contributions with respect to partners and sole proprietors are no longer treated as elective contributions.

3. Nonqualified CODAs

The proposed regulations would generally retain the rules in the existing regulations applicable to a nonqualified CODA (i.e., a CODA that fails one or more of the applicable requirements to be a qualified CODA). Because elective contributions under such an arrangement are not entitled to the constructive receipt relief set forth in section 402(e)(3), the contributions are currently taxable to the employee. In addition, the plan to which such contributions are made must satisfy any nondiscrimination requirements that would otherwise apply under section 401(a)(4).

4. The Actual Deferral Percentage (ADP) Test

A. General rules relating to the ADP test

Section 1.401(k)-2 sets forth the rules for a CODA that is applying the ADP test contained in section 401(k)(3). Under the ADP test, the percentage of compensation deferred for the eligible HCEs is compared annually to the percentage of compensation deferred for eligible NHCEs, and if certain limits are exceeded by the HCEs, corrective action must be taken by the plan. Correction can be made through the distribution of excess contributions, the recharacterization of excess contributions, or the contribution of additional employer contributions.

Section 401(k)(3)(A), as amended by SBJPA, generally provides for the use of prior year data in determining the ADP of NHCEs, while current year data is used for HCEs. This testing option is referred to as the prior year testing method. Alternatively, a plan may provide for the use of current year data for determining the ADPs for both NHCEs and HCEs, which is known as the current year testing method. The proposed regulations would use the term applicable year to describe the year for which the ADP is determined for the NHCEs.

Section 401(k)(3)(F), as added by SBJPA, provides that a plan benefitting otherwise excludable employees and that, pursuant to section 410(b)(4)(B), is being treated as two separate plans for purposes of section 410(b), is permitted to disregard NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A). Thus, the proposed regulations would permit such a plan to perform the

ADP test by comparing the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A). The proposed regulations treat this rule as permissive. Accordingly, the new statutory provision does not eliminate the existing testing option under which a plan benefitting otherwise excludable employees is disaggregated into separate plans where the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

B. Elective contributions used in the ADP test

The proposed regulations would generally follow the existing regulations in defining which elective contributions are reflected in the ADP test and which ones are not. The proposed regulations would reflect the rule contained in the regulations under section 414(v), under which catch-up contributions that are in excess of a statutory limit or an employer-provided limit are not taken into account under the ADP test. See §1.414(v). In addition, the proposed regulations would incorporate the rule in §1.402(g)-1 that provides excess deferrals that are distributed are still taken into account under the ADP test (with the exception of deferrals made by NHCEs that were in violation of section 401(a)(30)). The proposed regulations retain the rule that elective contributions must be paid to the trust within 12 months after the end of the plan year. However, for plans subject to Title I of ERISA, contributions must be paid to the trust much sooner in order to satisfy the Department of Labor's regulations relating to when elective contributions become plan assets.

Section 401(k)(3) provides that the actual deferral ratio (ADR) of an HCE who is eligible to participate in 2 or more CODAs of the same employer is calculated by treating all CODAs in which the employee is eligible to participate as one CODA. The existing regulations implement this rule by aggregating the elective contributions of such an HCE for all plan years that end with or within a single calendar year. This can yield an inappropriate result if the plan years are different, because more than 12 months of elective contributions could be included in an employee's ADR. These proposed regulations would modify this rule to provide that the ADR for each HCE participating in more than one CODA is determined by aggregating the HCE's elective contributions that are within the plan year of the CODA being tested. In addition, the definition of period of participation for purposes of determining compensation would be modified to take into account periods of participation under another plan where the elective contributions must be aggregated for an HCE. As a result, even in the case of plans with different plan years, each of the employer's CODAs will use 12 months of elective contributions and 12 months of compensation in determining the ADR for an HCE who participates in multiple arrangements.

The proposed regulations would retain the rule in the existing regulations that provides that the HCE aggregation of elective contributions under CODAs does not apply where the CODAs are within plans that cannot be aggregated under §1.410(b)-7(d), but only after applying the modifications to the section 410(b) aggregation and disaggregation rules for section 401(k) plans provided in the proposed regulations. The non-application of the HCE aggregation rule would have less significance in light of the change described above relating to the elimination of the required disaggregation of

ESOP and non-ESOP plans. In addition, the proposed regulations would clarify that, in determining whether two plans could be aggregated for this purpose, the prohibition on aggregating plans with CODAs that apply inconsistent testing methods set forth under these proposed regulations and the section 410(b) prohibition on aggregating plans that have different plan years would not apply.

C. Additional employer contributions used in the ADP test

The proposed regulations would generally retain the rules in the existing regulations permitting a plan to take qualified nonelective contributions or qualified matching contributions (i.e., nonelective or matching contributions that satisfy the vesting and distribution limitations of section 401(k)(2)(B) and (C)) into account under the ADP test, except as described below. Thus, an employer whose CODA has failed the ADP test can correct this failure by making additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) for its NHCEs. The proposed regulations would no longer describe such contributions as being treated as elective contributions under the arrangement, but would nonetheless permit such contributions to be taken into account under the ADP test.

As under the existing regulations, these proposed regulations would provide that QNECs must satisfy four requirements in addition to the vesting and distribution rules described above before they can be taken into account under the ADP test: 1) The amount of nonelective contributions, including the QNECs that are used under the ADP test or the ACP test, must satisfy section 401(a)(4); 2) the nonelective contributions, excluding the QNECs that are used under the ADP test or the ACP test, must satisfy section 401(a)(4); 3) the plan to which the QNEC or QMAC is made must be a plan that can be aggregated with the plan maintaining the CODA; and 4) the QNECs or QMACs must not be contingent on the performance of services after the allocation date and must be contributed within 12 months after the end of the plan year within which the contribution is to be allocated.[3] Thus, in the case of a plan using prior year ADP testing, any QNECs that are to be allocated to the NHCEs for the prior plan year must be contributed before the last day of the current plan year in order to be taken into account.

Some plans provide a correction mechanism for a failed ADP test that targets QNECs to certain NHCEs in order to reduce the total contributions to NHCEs under the correction. Under the method that minimizes the total QNECs allocated to NHCEs under the correction, the employer makes a QNEC to the extent permitted by the section 415 limits to the NHCE with the lowest compensation during the year in order to raise that NHCE's ADR. If the plan still fails to pass the ADP test, the employer continues expanding the group of NHCEs who receive QNECs to the next lowest-paid NHCE until the ADP test is satisfied. By using this bottom-up leveling technique, the

[3] With respect to this timing requirement, it should be noted that in order to be taken into account for purposes of section 415(c) for a limitation year, the contributions will need to be made no later than 30 days after the end of the section 404(a)(6) period applicable to the taxable year with or within which the limitation year ends.

employer can pass the ADP test by contributing small amounts of money to NHCEs who have very low compensation for the plan year (for example, an employee who terminated employment in early January with $300 of compensation). This is because of the fact that the ADP test is based on an unweighted average of ADRs and a small dollar (but high percentage of compensation) contribution to a terminated or other partial-year employee has a larger impact on the ADP test than a more significant contribution to a full-year employee.

The IRS and Treasury have been concerned that, by using these types of techniques, employers may pass the ADP test by making high percentage QNECs to a small number of employees with low compensation rather than providing contributions to a broader group of NHCEs. In addition, the legislative history to EGTRRA expresses Congressional intent that the Secretary of the Treasury will use his existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the ADP of the NHCEs. (See EGTRRA Conference Report, H.R. Conf. Rep. 107-84, 240).

Accordingly, the proposed regulations would add a new requirement that a QNEC must satisfy in order to be taken into account under the ADP test. This requirement, designed to limit the use of targeted QNECs, would generally treat a plan as providing impermissibly targeted QNECs if less than half of all NHCEs are receiving QNECs and would also treat a QNEC as impermissibly targeted if the contribution is more than double the QNECs other nonhighly compensated employees are receiving, when expressed as a percentage of compensation. However, QNECs that do not exceed 5% of compensation are never treated as targeted and would always satisfy the

new requirement.

This restriction on targeting QNECs would be implemented in the proposed regulations by providing that a QNEC that exceeds 5% of compensation could be taken into account for the ADP test only to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's representative contribution rate. The plan's representative contribution rate would be defined as the lowest contribution rate among a group of NHCEs that is half of all the eligible NHCEs under the arrangement (or the lowest contribution rate among all eligible NHCEs under the arrangement who are employed on the last day of the year, if greater). For purposes of determining an NHCE's contribution rate, the employee's qualified nonelective contributions and the qualified matching contributions taken into account under the ADP test for the plan year are added together and the sum is divided by the employee's compensation for the same period. The proposed regulations under section 401(m) would provide parallel restrictions on QNECs taken into account in ACP testing, and a QNEC cannot be taken into account under both the ADP and ACP test (including for purposes of determining the representative contribution rate). As discussed more fully below, the proposed regulations would also have a limitation on targeting matching contributions, which would limit the extent to which QMACs can be targeted as a means of avoiding the restrictions on targeted QNECs.

The proposed regulations would also implement a prohibition against double counting of QNECs that was set forth in Notice 98-1. Generally, QNECs used in an ADP or ACP test, used to satisfy the safe harbor under section 401(k), or under a SIMPLE 401(k) plan can not be used again to demonstrate compliance with another test under section 401(k)(3) or 401(m)(2). For example, double counting could arise when QNECs on behalf of NHCEs are used to determine the ADP under current year testing in year 1 and then, if the employer elected prior year testing, are used again in year 2 to determine the ADP of NHCEs. However, unlike Notice 98-1, these proposed regulations would not contain the additional limitations on double counting elective contributions or matching contributions that were moved between the ADP and ACP tests.

D. Correction

Section 401(k)(8)(C), as amended by the SBJPA, provides that, for purposes of correcting a plan's failure to meet the nondiscrimination requirements of section 401(k)(3), distribution of excess contributions is made on the basis of the amount of the contributions by, or on behalf of, each HCE. The proposed regulations would implement this correction procedure in the same manner as set forth in Notice 97-2. Thus, the total amount of excess contributions is determined using the rules under the existing final regulations (i.e., based on high percentages). Then that total amount is apportioned among the HCEs by assigning the excess to be distributed first to those HCEs who have the greatest dollar amount of contributions taken into account under the ADP test (as opposed to the highest deferral percentage). If these amounts are distributed or recharacterized in accordance with these regulations, the plan complies with the ADP test for the plan year with no obligation to recalculate the ADP test.

The proposed regulations would provide a special rule for correcting through distribution of excess contributions in the case of an HCE who participates in multiple plans with CODAs. In that case, the proposed regulations would provide that, for

purposes of determining which HCE will be apportioned a share of the total excess contributions to be distributed from a plan, all contributions in CODAs in which such an HCE participates are aggregated and the HCE with the highest dollar amount of contributions will apportioned excess contributions first. However, only actual contributions under the plan undergoing correction -- rather than all contributions taken into account in calculating the employee's ADR -- may be distributed from a plan. If the high dollar HCE's actual contributions under the plan are insufficient to allow full correction, then the HCE with the next highest dollar amount of contributions is apportioned the remaining excess contributions. If additional correction is needed, this process is repeated until the excess contributions are completely apportioned. This correction mechanism is applied independently to each CODA in which the HCE participates. If correction is needed in more than one CODA, the ADRs of HCEs who have received corrective distributions under the other arrangements are not recalculated after correction in the first plan.

The proposed regulations would generally follow the rules in the existing regulations on the determination of net income attributable to excess contributions. The existing regulations provide for a reasonable determination of net income attributable to an excess contribution, but do not specify which contribution within the plan year is to be treated as the excess contribution to be distributed. This provision would be retained in the proposed regulations along with the existing alternative method of determining the net income, which approximates the result that would apply if the excess contribution is made on the first day of the plan year. However, to the extent the employee is or will be credited with allocable gain or loss on those excess contributions for the period after the end of the plan year (the gap period), the proposed regulations would now require that income be determined for that period. As under the existing regulations, the determination of the income for the gap period could be based on the income determined using the alternative method for the aggregate of the plan year and the gap period or using 10% of the income for the plan year (determined under the alternative method) for each month in the gap period.

The proposed regulations would permit the recharacterization of excess contributions in a manner that generally follows the existing regulations. However, the year the employee must include the recharacterized contribution in current income has been changed to match the year that the employee would have had to include the excess contribution in income, had it been distributed. Thus, if the recharacterized amount is less than $100, it is included in gross income in the year that it is recharacterized, rather than the year of the earliest elective contributions for the employee.

The proposed regulations would retain the rules in the existing regulations regarding the timing and tax treatment of distributions of excess contributions, coordination with the distribution of excess deferrals and the treatment of matches attributable to excess contributions.

E. Special rules relating to prior year testing

The proposed regulations would generally follow the rules set forth in Notice 98-1 regarding prior year testing, including the limitations on switching from current year testing to prior year testing. However, the proposed regulations would provide that a plan is permitted to be inconsistent between the choice of current year testing method and prior year testing method, as applied for ADP purposes and ACP purposes. In such a case, any movement of elective contributions or QMACs between the ADP and ACP tests (including recharacterization) would be prohibited.

The proposed regulations would generally incorporate the rules set forth in Notice 98-1 relating to plan coverage changes in the case of a plan using prior year testing. Thus, in the case of a plan that uses prior year testing and experiences a plan coverage change affecting more than 10% of the NHCEs, the ADP of the NHCEs would generally be determined as the weighted average of the ADP of the NHCEs of the plans in which the NHCEs participated in the prior year. The definition of plan coverage change includes changes in the group of eligible employees under a plan resulting from the establishment or amendment of a plan, a plan merger or spin-off or a change in the way plans are combined or separated under the section 410(b) rules. The definition under the proposed regulations would also include a reclassification of a substantial group of employees that has the same effect as amending the plan. These proposed regulations retain the rule that a plan that experiences coverage changes affecting 10% or less of the NHCEs disregards those changes in calculating the ADP for the NHCEs. Similarly, a plan that merely experiences a spin-off is not required to recalculate the ADP for the NHCEs.

5. Safe Harbor Section 401(k) Plans

Section 401(k)(12) provides a design-based safe harbor method under which a CODA is treated as satisfying the ADP test if the arrangement meets certain contribution and notice requirements. Section 1.401(k)-3 of these proposed regulations, which sets forth the requirements for these arrangements, generally follows the rules set forth in Notice 98-52 and Notice 2000-3. Thus, a plan satisfies the section 401(k) safe harbor if it makes specified QMACs for all eligible NHCEs. The matching contributions can be under a basic matching formula that provides for QMACs equal to 100% of the first 3% of elective contributions and 50% of the next 2% or an enhanced matching formula that is at least as generous in the aggregate, provided the rate of matching contributions under the enhanced matching formula does not increase as the employee's rate of elective contributions increases. In lieu of QMACs, the plan is permitted to provide QNECs equal to 3% of compensation for all eligible NHCEs. In addition, notice must be provided to each eligible employee, within a reasonable time before the beginning of the year, of their right to defer under the plan.

A plan using the safe harbor method must also comply with certain other requirements. Among these is the requirement in section 401(k)(12)(B)(ii) that provides that the rate of matching contribution for any elective contribution on the part of any HCE cannot exceed the rate of matching contribution that would apply to any NHCE with the same rate of elective contribution. Notice 98-52 advised that the general rules on aggregating contributions for HCEs eligible under more than one CODA would apply for this purpose. The IRS and Treasury have determined that such aggregation is not applicable under the ADP safe harbor. Accordingly, these proposed regulations would not require that elective or matching contributions on behalf of an HCE who is eligible to participate in more than one plan of the same employer be aggregated for purposes of the requirement of section 401(k)(12)(B)(ii). Thus, the rate of match for purposes of determining whether an HCE has a higher matching rate is based only on matching contributions with respect to elective contributions under the safe harbor plan.

However, for an employer that uses the safe harbor method of satisfying the ACP test, the rule in Notice 98-52 is retained for applying the ACP safe harbor, with an exception for nonsimultaneous participation (as discussed in connection with the ACP safe harbor below).

These proposed regulations do not provide any rules relating to suspension of employee contributions under a plan that provides that safe harbor matching contributions are made with respect to the sum of elective contributions and employee contributions. Although Notice 2000-3 specifically permitted suspension of employee contributions in certain circumstances, the IRS and Treasury have determined that there are no limits on suspending employee contributions, provided that safe harbor matching contributions are made with respect to elective contributions. This is because the restrictions on suspension of elective contributions are sufficient to ensure an eligible NHCE can get the full matching contribution.

The proposed regulations do not include any exception to the requirements for safe harbor matching contributions with respect to catch-up contributions. Treasury and the IRS are aware that there are questions concerning the extent to which catch up contributions are required to be matched under a plan that provides for safe harbor matching contributions. Treasury and the IRS are interested in comments on the specific circumstances under which elective contributions by a NHCE to a safe harbor plan would be less than the amount required to be matched, e.g., less than 5% of safe harbor compensation, but would be treated by the plan as catch-up contributions, and on the extent to which a safe harbor plan should be required to match catch-up contributions under such circumstances.

Section 401(k)(12)(D) contains a requirement that each eligible employee be provided with a notice of the employee's rights and obligations under the plan. These proposed regulations do not address the extent to which the notice can be provided through electronic media. As noted in the preamble to other regulations, the IRS and the Treasury Department are considering the extent to which the notice described in section 401(k)(12)(D), as well as other notices under the various Internal Revenue Code requirements relating to qualified retirement plans, can be provided electronically, taking into account the effect of the Electronic Signatures in Global and National Commerce Act (E-SIGN), Public Law 106-229 (114 Stat. 464 (2000)). The IRS and the Treasury Department anticipate issuing proposed regulations regarding these issues, and invite comments on these issues. Until those proposed regulations are issued, plan administrators and employers may continue to rely on the interim guidance in Q&A-7 of Notice 2000-3 on use of electronic media to satisfy the notice requirement in section 401(k)(12)(D).

These proposed regulations would clarify that a section 401(k) safe harbor plan must generally be adopted before the beginning of the plan year and be maintained throughout a full 12-month plan year. This requirement is consistent with the notion that the statute specifies a certain contribution level for nonhighly compensated employees in order to be deemed to pass the nondiscrimination requirements. If the contribution level is not maintained for a full 12-month year, the employer contributions made on behalf of nonhighly compensated employees should not support what could be a full year's contribution by the highly compensated employees.

The proposed regulations would adopt the exception to the requirement that a section 401(k) safe harbor plan be in place before the beginning of the plan year that was provided in Notice 2000-3. Under that option, an employer could adopt a section 401(k) safe harbor plan which has contingent non-elective contributions, provided the employer notifies employees of this contingent arrangement before the start of the year, amends the plan to provide the nonelective contributions no less than 30 days before the end of the year, and provides employees with a follow-up notice if the contribution will be made. Similarly, the proposed regulations would adopt the exception for a section 401(k) safe harbor plan that uses the matching contribution alternative. Under that exception, an employer can amend the plan to eliminate matching contributions with respect to future elective deferrals, provided that the matching contributions are made with respect to pre-amendment elective deferrals, employees are provided with notice of the change and the opportunity to change their elections, and the plan satisfies the ADP or ACP test for the plan year using the current year testing method.

The proposed regulations would recognize the practical difficulty in a 12-month requirement by following the rule in Notice 98-52 that allowed a short plan year in the first plan year and would allow a short plan year in certain other circumstances. Specifically, a section 401(k) safe harbor plan could have a short plan year in the year the plan terminates, if the plan termination is in connection with a merger or acquisition involving the employer, or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(d). In addition, a section 401(k) safe harbor plan could have a short plan year if the plan terminates, the employer makes the safe harbor contributions for the short year, employees are provided notice of the change, and the plan passes the ADP test. Finally, a safe harbor plan could have a short plan year if it is preceded and followed by 12-month plan years as a section 401(k) safe harbor plan.

Under section 401(k)(12)(F), safe harbor contributions are permitted to be made to a plan other than the plan that contains the CODA. These proposed regulations reflect that rule and provide that the plan to which the safe harbor contributions are made need not be a plan that can be aggregated with the plan that contains the cash or deferred arrangement.

Whether a contribution is taken into account for purposes of the safe harbor is determined in accordance with the rules regarding inclusion in ADP testing under proposed §1.401(k)-2(a). Thus, for example, a plan that provides for safe harbor matching contributions in 2006 need not provide for a matching contribution with respect to an elective contribution made during the first 2½ months of 2007 and attributable to service during 2006, unless that elective contribution is taken into account for 2006.

6. SIMPLE 401(k) Plans

Pursuant to section 401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the requirements of section 401(k)(3)(A)(ii) if the contribution, vesting, notice and exclusive plan requirements of section 401(k)(11) are satisfied. Section 1.401(k)-4 of these proposed regulations reflects the provisions of section 401(k)(11) in a manner that follows the positions reflected in the model amendments set forth in Rev. Proc. 97-9.

7. Matching Contributions and Employee Contributions.

Section 401(m)(2) sets forth a nondiscrimination test, the ACP test, with respect to matching contributions and employee contributions that is parallel to the nondiscrimination test for elective contributions set forth in section 401(k). Section

1.401(m)-1 of the proposed regulations would set forth this test in a manner that is consistent with the nondiscrimination test set forth in proposed §1.401(k)-1(b). Thus, satisfaction of the ACP test, the ACP safe harbor or the SIMPLE 401(k) provisions of the proposed regulations under section 401(k) are the exclusive means that matching contributions and employee contributions can use to satisfy the nondiscrimination in amount of contribution requirements of section 401(a)(4). An anti-abuse provision comparable to that provided in connection with the proposed regulations under section 401(k) limits the ability of an employer to make repeated changes in plan provisions or testing procedures that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise manipulate the nondiscrimination rules of section 401(m), if a principal purpose of the changes was to achieve such a result.

These proposed regulations also include provisions regarding plan aggregation and disaggregation that are similar to those proposed for CODAs under section 401(k). For example, matching contributions made under the portion of a plan that is an ESOP and the portion of the same plan that is not an ESOP would not be disaggregated under these proposed regulations.

The definitions of matching contribution and employee contribution under §1.401(m)-1 of the proposed regulations would generally follow the definitions in the existing regulations. Thus, whether an employer contribution is on account of an elective deferral or employee contribution – and thus is a matching contribution -- is determined based on all the relevant facts and circumstances. However, the proposed regulations would provide that a contribution would not be treated as a matching contribution on account of an elective deferral if it is contributed before the employee's performance of services with respect to which the elective deferral is made (or when the cash that is subject to the cash or deferred election would be currently available, if earlier) and an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution. Thus, under these regulations, an employer would not be able to prefund matching contributions to accelerate the deduction for those contributions and, as noted above with respect to the timing of elective contributions, employer contributions made under the facts in Notice 2002-48 would not be taken into account under the ACP test and would not satisfy any plan requirement to provide matching contributions.

8. <u>ACP Test for Matching Contributions and Employee Contributions</u>

Section 1.401(m)-2 of the proposed regulations would provide rules for the ACP test that generally parallel the rules applicable to the ADP test in proposed §1.401(k)-2. Thus, for example, the ACP test may be run by comparing the ACP for eligible HCEs for the current year with the ACP for eligible NHCEs for either the current plan year or the prior plan year. Similarly, the proposed regulations reflect the special ACP testing rule in section 401(m)(5)(C) for a plan that provides for early participation, comparable to the special ADP testing rule in section 401(k)(3)(F), as set forth in proposed §1.401(k)-2(a)(1)(iii).

The determination of the actual contribution ratio (ACR) for an eligible employee, and the contributions that are taken into account in determining that ACR, under these proposed regulations are comparable to the rules under the proposed section 401(k) regulations. Thus, for example, the ACR for an HCE who has matching contributions or employee contributions under two or more plans is determined by adding together matching contributions and employee contributions under all plans of the employer during the plan year of the plan being tested, in a manner comparable to that for determining the ADR of an HCE who participates in two or more CODAs.

The proposed regulations would retain the rule from the existing regulations under which a QMAC that is taken into account in the ADP test is excluded from the ACP test. In addition, the proposed regulations would continue to allow QNECs to be taken into account for ACP testing, but would provide essentially the same restrictions on targeting QNECs to a small number of NHCEs as is provided in proposed §1.401(k)-2. The only difference in the rules would be that the contribution percentages used to determine the lowest contribution percentage would be based on the sum of the QNECs and those matching contributions taken into account in the ACP test, rather than the sum of the QNECs and the QMACs taken into account under the ADP test. Because QNECs that do not exceed 5% are not subject to the limits on targeted QNECs under either the ADP test or the ACP test, an employer is permitted to take into account up to 10% in QNECs for an eligible NHCE, 5% in ADP testing and 5% in ACP testing, without regard to how many NHCEs receive QNECs.

In addition, to prevent an employer from using targeted matching contributions to circumvent the limitation on targeted QNECs, the proposed regulations would provide that matching contributions are not taken into account in the ACP test to the extent the matching rate for the contribution exceeds the greater of 100% and 2 times the representative matching rate. Paralleling the rule to limit targeted QNECs, the representative plan matching rate is the lowest matching rate for any eligible employee in a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year (or the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year, if greater). For this purpose, the matching rate is the ratio of the matching contributions to the contributions that are being matched, and only NHCEs who make elective deferrals or employee contributions for the plan year are taken into account.

The proposed regulations would set limits on the use of elective contributions in the ACP test that are in addition to the rules in the existing regulations under which elective contributions may be taken into account for the ACP test only to the extent the plan satisfies the ADP test, determined by including such elective contributions in the ADP test. Under the new rule, the proposed regulations would provide that elective contributions under a plan that is not subject to the ADP test, such as a plan that uses the safe harbor method of section 401(k)(12) or a contract or arrangement subject to the requirements of section 403(b)(12)(A)(ii), may not be taken into account for the ACP test. In the absence of this prohibition, contributions that are not properly considered "excess" could be taken into account under the ACP test.

The provisions of these proposed regulations regarding correction of excess aggregate contributions, including allocation of excess aggregate contributions and determination of allocable income, would generally be consistent with the provisions of the proposed regulations under section 401(k). These proposed regulations continue the provisions of the current regulations regarding correction through distribution of vested matching contributions and forfeiture of unvested matching contributions. Similarly, the proposed regulations reflect the provisions of section 411(a)(3)(G) which permit the forfeiture of a matching contribution made with respect to an excess deferral, excess contribution, or excess aggregate contribution. This provision is necessary to allow forfeiture of matching contributions that would otherwise violate section 401(a)(4).

9. Safe Harbor Section 401(m) Plans

Section 401(m)(11) provides a design-based safe harbor method of satisfying the ACP test contained in section 401(m)(2). Under section 401(m)(11), a defined contribution plan is treated as satisfying the ACP test with respect to matching contributions if the plan satisfies the ADP safe harbor of section 401(k)(12) and matching contributions are not made with respect to employee contributions or elective contributions in excess of 6% of an employee's compensation. For a plan that satisfies the ADP safe harbor using a 3% nonelective contribution, two additional requirements that apply to a plan that satisfies the ADP safe harbor using matching contributions also apply: 1) the rate of an employer's matching contribution does not increase as the rate of employee contributions or elective deferrals increase; and 2) the matching contribution with respect to any HCE at any rate of employee contribution or elective deferral is not greater than with respect to any NHCE. In addition, the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals and employee contributions for a plan year cannot be greater than the ratio of matching contributions to elective deferrals or employee contributions that would apply with respect to any NHCE who contributes (as an elective deferral or employee contribution) the same percentage of safe harbor compensation for that plan year.

Section 1.401(m)-3 of these proposed regulations, which sets forth the requirements for these plans, would generally follow the rules set forth in Notice 98-52 and Notice 2000-3. These proposed regulations would clarify that, for purposes of determining whether an HCE has a higher rate of matching contributions than any NHCE, any NHCE who is an eligible employee under the safe harbor CODA must be taken into account, even if the NHCE is not eligible for a matching contribution. This means that a plan with a provision which limits matching contributions to employees who are employed on the last day of the plan year will not be able to satisfy the ACP safe harbor, since a NHCE who is not eligible to receive a matching contribution on account of the last day requirement will nonetheless be taken into consideration in determining whether the plan satisfies section 401(m)(11)(B)(iii). The proposed regulations also include the requirement that matching contributions made at the employer's discretion with respect to any employee cannot exceed a dollar amount equal to 4% of the employee's compensation and that a safe harbor plan must permit all eligible NHCEs to make sufficient elective contributions (or employee contributions, if applicable) to receive the maximum matching contribution provided under the plan.

The proposed regulations would provide a special rule for satisfying section 401(m)(11)(B)(iii) in the case of an HCE who participates in two or more plans that provide for matching contributions. Under this rule, a plan will not fail to satisfy the requirements of section 401(m)(11)(B)(iii) merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that the HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and the period used to determine compensation for purposes of determining matching contributions under each such plan is limited to periods when the HCE participated in the plan. In such a case, an HCE can transfer from a plan with a more generous matching schedule to an otherwise safe harbor section 401(m) plan (for example, as a result of switching jobs within the controlled group) without causing the safe harbor plan to violate section 401(m)(11). However, the plan which is not the safe harbor plan will still have to aggregate matching contributions for the HCE under the rule set forth in section 401(m)(2)(B).

The safe harbor in section 401(m)(11) does not apply to employee contributions. Consequently, a plan that provides for employee contributions and matching contributions must satisfy the ACP test even though the matching contributions satisfy the safe harbor requirements for section 401(m)(11). However, the proposed regulations would also adopt the position in Notice 98-52 that the ACP test is permitted to be applied by disregarding all matching contributions with respect to all eligible employees. If the ADP safe harbor using matching contributions is satisfied but the ACP safe harbor is not satisfied, the proposed regulations would adopt the position in Notice 98-52 that the ACP test is permitted to be applied disregarding matching contributions for any employee that do not exceed 4% of compensation.

Proposed Effective Date

The regulations are proposed to apply for plan years beginning no sooner than 12 months after publication of final regulations in the **Federal Register**. However, it is anticipated that the preamble for the final regulations will permit plan sponsors to implement the final regulations for the first plan year beginning after publication of final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the conclusion that few plans containing qualified CODAs will correct excess contributions through the recharacterization of these amounts as employee contributions under §1.401(k)-2(b)(3) of these proposed regulations. The collections of information contained in §§1.401(k)-3(d), (f) and 1.401(m)-3(e) are required by statutory provisions. However, the IRS has considered alternatives that would lessen the impact of these statutory requirements on small entities and has requested comments on the use of electronic media to satisfy these notice requirements. Thus, the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. In addition to the other requests for comments set forth in this document, the IRS and Treasury also request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 12, 2003, at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue, NW., entrance, located between 10th and 12th Streets, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

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

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 22, 2003.

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

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

Drafting Information

The principal authors of these regulations are R. Lisa Mojiri-Azad and John T. Ricotta of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and

Government Entities). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to The Regulations

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

PART 1--INCOME TAXES

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

Authority: 26 U.S.C. 7805

26 U.S.C. 401(m)(9) * * *

Par. 2. Sections 1.401(k)-0 and 1.401(k)-1 are revised and §§1.401(k)-2 through 1.401(k)-6 are added to read as follows:

§1.401(k)-0 Table of contents.

This section contains first a list of section headings and then a list of the paragraphs in each section in §§1.401(k)-1 through 1.401(k)-6.

LIST OF SECTIONS

LIST OF PARAGRAPHS

§1.401(k)-1 Certain cash or deferred arrangements.

(i) Cash must be available.
(ii) Frequency of elections.
(3) Separate accounting requirement.
(i) General rule.
(ii) Satisfaction of separate accounting requirement.
(4) Limitations on cash or deferred arrangements of state and local governments.
(i) General rule.
(ii) Rural cooperative plans and Indian tribal governments.
(iii) Adoption after May 6, 1986.
(iv) Adoption before May 7, 1986.
(5) One-year eligibility requirement.
(6) Other benefits not contingent upon elective contributions.
(i) General rule.
(ii) Definition of other benefits.
(iii) Effect of certain statutory limits.
(iv) Nonqualified deferred compensation.
(v) Plan loans and distributions.
(vi) Examples.
(7) Plan provision requirement.
(f) Effective dates.
(1) General rule.
(2) Collectively bargained plans.

§1.401(k)-2 ADP test.

(a) Actual deferral percentage (ADP) test.
(1) In general.
(i) ADP test formula.
(ii) HCEs as sole eligible employees.
(iii) Special rule for early participation.
(2) Determination of ADP.
(i) General rule.
(ii) Determination of applicable year under current year and prior year testing method.
(3) Determination of ADR.
(i) General rule.
(ii) ADR of HCEs eligible under more than one arrangement.
(A) General rule.
(B) Plans not permitted to be aggregated.
(iii) Examples.
(4) Elective contributions taken into account under the ADP test.
(i) General rule.
(ii) Elective contributions for partners and self-employed individuals.
(iii) Elective contributions for HCEs.
(5) Elective contributions not taken into account under the ADP test.
(i) General rule.

<u>§1.401(k)-3 Safe harbor requirements</u>.

§1.401(k)-1 Certain cash or deferred arrangements.

(a) General rules--(1) Certain plans permitted to include cash or deferred arrangements. A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

(2) Rules applicable to cash or deferred arrangements generally--(i) Definition of cash or deferred arrangement. Except as provided in paragraphs (a)(2)(ii) and (iii) of this section, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a)).

(ii) Treatment of after-tax employee contributions. A cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions (e.g., by treating the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). This is the case even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(iii) Treatment of ESOP dividend election. A cash or deferred arrangement does not include an arrangement under an ESOP under which dividends are either distributed or invested pursuant to an election made by participants or their beneficiaries in accordance with section 404(k)(2)(A)(iii).

(iv) Treatment of elective contributions as plan assets. The extent to which elective contributions constitute plan assets for purposes of the prohibited transaction provisions of section 4975 and Title I of the Employee Retirement Income Security Act of 1974 is determined in accordance with regulations and rulings issued by the Department of Labor. See 29 CFR 2510.3-102.

(3) Rules applicable to cash or deferred elections generally--(i) Definition of cash or deferred election. A cash or deferred election is any direct or indirect election (or modification of an earlier election) by an employee to have the employer either--

(A) Provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available; or

(B) Contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

(ii) Automatic enrollment. For purposes of determining whether an election is a cash or deferred election, it is irrelevant whether the default that applies in the absence of an affirmative election is described in paragraph (a)(3)(i)(A) of this section (i.e., the employee receives an amount in cash or some other taxable benefit) or in paragraph (a)(3)(i)(B) of this section (i.e., the employer contributes an amount to a trust or provides an accrual or other benefit under a plan deferring the receipt of compensation).

(iii) Rules related to timing--(A) Requirement that amounts not be currently available. A cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

(B) Contribution may not precede election. A contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made. In addition, a contribution is made pursuant to a cash or deferred election only if the contribution is made after the employee's performance of services with respect to which the contribution is made (or when the cash or other taxable benefit would be currently available, if earlier).

(iv) Current availability defined. Cash or another taxable benefit is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable benefit at the employee's discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(v) Certain one-time elections not treated as cash or deferred elections. A cash or deferred election does not include a one-time irrevocable election upon an employee's commencement of employment with the employer, or upon the employee's first becoming eligible under the plan or any other plan of the employer (whether or not such other plan has terminated), to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and a specified amount or percentage of the employee's compensation (including no amount of compensation) divided among all other plans of the employer (including plans not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under such plans. Thus, for example, employer contributions made pursuant to a one-time irrevocable election described in this paragraph are not treated as having been made pursuant to a cash or deferred election and are not includible in an employee's gross income by reason of §1.402(a)-1(d). In the case of an irrevocable election made on or before December 23, 1994--

(A) The election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because an employee was previously eligible under another plan of the employer (whether or not such other plan has terminated); and

(B) In the case of a plan in which partners may participate, the election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because the election was made after commencement of employment or after the employee's first becoming eligible under any plan of the employer, provided that the election was made before the first day of the first plan year beginning after December 31,1988, or, if later, March 31,1989.

(vi) Tax treatment of employees. An amount generally is includible in an employee's gross income for the taxable year in which the employee actually or constructively receives the amount. But for sections 402(e)(3) and 401(k), an employee is treated as having received an amount that is contributed to a plan pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which the amount is earned, or before the amount is currently available. See §1.402(a)-1(d).

(vii) Examples. The following examples illustrate the application of paragraph (a)(3) of this section:

Example 1. (i) An employer maintains a profit-sharing plan under which each eligible employee has an election to defer an annual bonus payable on January 30 each year. The bonus equals 10% of compensation during the previous calendar year. Deferred amounts are not treated as after-tax employee contributions. The bonus is currently available on January 30.

(ii) An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election, and the bonus deferral arrangement is a cash or deferred arrangement.

Example 2. (i) An employer maintains a profit-sharing plan which provides for discretionary profit sharing contributions and under which each eligible employee may elect to reduce his compensation by up to 10% and to have the employer contribute such amount to the plan. The employer pays each employee every two weeks for services during the immediately preceding two weeks. The employee's election to defer compensation for a payroll period must be made prior to the date the amount would otherwise be paid. The employer contributes to the plan the amount of compensation that each employee elected to defer, at the time it would otherwise be paid to the employee, and does not treat the contribution as an after-tax employee contribution.

(ii) The election is a cash or deferred election and the contributions are elective contributions.

Example 3. (i) The facts are the same as in Example 2, except that the employer makes a $10,000 contribution on January 31 of the plan year that is in addition to the contributions that satisfy the employer's obligation to make contributions with respect to cash or deferred elections for prior payroll periods. Employee A makes an election on February 15 to defer $2,000 from compensation that is not currently available and the employer reduces the employee's compensation to reflect the election.

(ii) None of the additional $10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election, because the contribution was made before the election was made. Accordingly, the employer must make an additional contribution of $2,000 in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The $10,000 contribution can be allocated under the plan terms providing for discretionary profit sharing contributions.

Example 4. (i) The facts are the same as in Example 3, except that Employee A had an outstanding election to defer $500 from each payroll period's compensation.

(ii) None of the additional $10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election for future payroll periods, because the contribution was made before the earlier of Employee A's performance of services to which the contribution is attributable or when the compensation would be currently available. Accordingly, the employer must make an additional contribution of $500 per payroll period in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The $10,000 contribution can be allocated under the plan terms providing for discretionary profit sharing contributions.

Example 5. (i) Employer B establishes a money purchase pension plan in 1986. This is the first qualified plan established by Employer B. All salaried employees are eligible to participate under the plan. Hourly-paid employees are not eligible to participate under the plan. In 2000, Employer B establishes a profit-sharing plan under which all employees (both salaried and hourly) are eligible. Employer B permits all employees on the effective date of the profit-sharing plan to make a one-time irrevocable election to have Employer B contribute 5% of compensation on their behalf to the plan and make no other contribution to any other plan of Employer B (including plans not yet established) for the duration of the employee's employment with Employer B, and have their salaries reduced by 5%.

(ii) The election provided under the profit-sharing plan is not a one-time irrevocable election within the meaning of paragraph (a)(3)(v) of this section with respect to the salaried employees of Employer B who, before becoming eligible to participate under the profit-sharing plan, became eligible to participate under the money purchase pension plan. The election under the profit-sharing plan is a one-time irrevocable election within the meaning of paragraph (a)(3)(v) of this section with respect to the hourly employees, because they were not previously eligible to participate under another plan of the employer.

(4) Rules applicable to qualified cash or deferred arrangements--(i) Definition of qualified cash or deferred arrangement. A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section.

(ii) Treatment of elective contributions as employer contributions. Except as otherwise provided in §1.401(k)-2(b)(3), elective contributions under a qualified cash or deferred arrangement are treated as employer contributions. Thus, for example, elective contributions are treated as employer contributions for purposes of sections

401(a) and 401(k), 402, 404, 409, 411, 412, 415, 416, and 417.

(iii) Tax treatment of employees. Except as provided in section 402(g), 402A (effective for years beginning after December 31, 2005), or 1.401(k)-2(b)(3), elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan. See §1.402(a)-1(d)(2)(i).

(iv) Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement--(A) Exclusive means of amounts testing. Elective contributions under a qualified cash or deferred arrangement satisfy the requirements of section 401(a)(4) with respect to amounts if and only if the amount of elective contributions satisfies the nondiscrimination test of section 401(k) under paragraph (b)(1) of this section. See §1.401(a)(4)-1(b)(2)(ii)(B).

(B) Testing benefits, rights and features. A plan that includes a qualified cash or deferred arrangement must satisfy the requirements of section 401(a)(4) with respect to benefits, rights and features in addition to the requirements regarding amounts described in paragraph (a)(4)(iv)(A) of this section. For example, the right to make each level of elective contributions under a cash or deferred arrangement is a benefit, right or feature subject to the requirements of section 401(a)(4). See §1.401(a)(4)-4(e)(3)(i) and (iii)(D). Thus, for example, if all employees are eligible to make a stated level of elective contributions under a cash or deferred arrangement, but that level of contributions can only be made from compensation in excess of a stated amount, such as the Social Security taxable wage base, the arrangement will generally favor HCEs with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4).

(C) Minimum coverage requirement. A qualified cash or deferred arrangement is treated as a separate plan that must satisfy the requirements of section 410(b). See §1.410(b)-7(c)(1) for special rules. The determination of whether a cash or deferred arrangement satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. See also §1.401(a)(4)-11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(5) Rules applicable to nonqualified cash or deferred arrangements--(i) Definition of nonqualified cash or deferred arrangement. A nonqualified cash or deferred arrangement is a cash or deferred arrangement that fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section.

(ii) Treatment of elective contributions as nonelective contributions. Except as specifically provided otherwise, elective contributions under a nonqualified cash or deferred arrangement are treated as nonelective employer contributions. Thus, for example, the elective contributions are treated as nonelective employer contributions for purposes of sections 401(a) (including section 401(a)(4)) and 401(k), 404, 409, 411, 412, 415, 416, and 417 and are not subject to the requirements of section 401(m).

(iii) Tax treatment of employees. Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the cash or other taxable amount that the employee would have received (but for the cash or deferred election) would have been includible in the employee's gross income.

See §1.402(a)-1(d)(1).

(iv) Qualification of plan that includes a nonqualified cash or deferred arrangement-- (A) In general. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a nonqualified cash or deferred arrangement. In determining whether the plan satisfies the requirements of section 401(a)(4), the nondiscrimination tests of sections 401(k), paragraph (b)(1) of this section, section 401(m)(2) and §1.401(m)-1(b) may not be used. See §§1.401(a)(4)-1(b)(2)(ii)(B) and 1.410(b)-9 (definition of section 401(k) plan).

(B) Application of section 401(a)(4) to certain plans. The amount of employer contributions under a nonqualified cash or deferred arrangement is treated as satisfying section 401(a)(4) if the arrangement is part of a collectively bargained plan that automatically satisfies the requirements of section 410(b). See §§1.401(a)(4)-1(c)(5) and 1.410(b)-2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof). See sections 401(a)(5) and 410(c)(1)(A).

(v) Example. The following example illustrates the application of this paragraph (a)(5):

Example. (i) For the 2006 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement do not satisfy the nondiscrimination test of section 401(k) and paragraph (b) of this section.

(ii) The arrangement is a nonqualified cash or deferred arrangement. The employer contributions under the cash or deferred arrangement are considered to be nondiscriminatory under section 401(a)(4), and the elective contributions are generally treated as employer contributions under paragraph (a)(5)(ii) of this section. Under paragraph (a)(5)(iii) of this section and under §1.402(a)-1(d)(1), however, the elective contributions are includible in each employee's gross income.

(6) Rules applicable to cash or deferred arrangements of self-employed individuals --(i) Application of general rules. Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf. Consistent with §1.402(a)-1(d), the elective contributions under such an arrangement are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement (i.e., the requirements of section 401(k) and this section are satisfied). Also, even if the arrangement is a qualified cash or deferred arrangement, the elective contributions are includible in gross income and are not deductible under section 404(a) to the extent they exceed the applicable limit under section 402(g). See also §1.401(a)-30.

(ii) Treatment of matching contributions made on behalf of self-employed individuals. Under section 402(g)(8), matching contributions made on behalf of a self-employed individual are not treated as elective contributions made pursuant to a cash or deferred election, without regard to whether such matching contributions indirectly permit individual partners to vary the amount of contributions made on their behalf.

(iii) Timing of self-employed individual's cash or deferred election. For purposes of paragraph (a)(3)(iv) of this section, a partner's compensation is deemed currently available on the last day of the partnership taxable year and a sole proprietor's compensation is deemed currently available on the last day of the individual's taxable year. Accordingly, a self-employed individual may not make a cash or deferred election with respect to compensation for a partnership or sole proprietorship taxable year after the last day of that year. See §1.401(k)-2(a)(4)(ii) for the rules regarding when these contributions are treated as allocated.

(b) Coverage and nondiscrimination requirements--(1) In general. A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if--

(i) The group of eligible employees under the cash or deferred arrangement (including any employee taken into account for purposes of section 410(b) pursuant to §1.401(a)(4)-11(g)(3)(vii)(A)) satisfies the requirements of section 410(b) (including the average benefit percentage test, if applicable); and

(ii) The cash or deferred arrangement satisfies--

(A) The ADP test of section 401(k)(3) described in §1.401(k)-2;

(B) The ADP safe harbor provisions of section 401(k)(12) described in §1.401(k)-3; or

(C) The SIMPLE 401(k) provisions of section 401(k)(11) described in §1.401(k)-4.

(2) Automatic satisfaction by certain plans. Notwithstanding paragraph (b)(1) of this section, a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof) shall be treated as meeting the requirements of this paragraph (b).

(3) Anti-abuse provisions. Sections 1.401(k)-1 through 1.401(k)-6 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) Aggregation and restructuring--(i) In general. This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans and cash or deferred arrangements for purposes of this section, and §§1.401(k)-2 through 1.401(k) -6.

(ii) Aggregation of cash or deferred arrangements within a plan. Except as otherwise specifically provided in this paragraph (b)(4), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement and a plan must apply a single test under paragraph (b)(1)(ii) of this section with respect to all such arrangements within the plan. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, all contributions under both cash or deferred arrangements must be treated as made under a single cash or deferred arrangement subject to a single test, even if they have significantly different features, such as different limits on elective contributions.

(iii) Aggregation of plans--(A) In general. For purposes of this section and §§1.401(k)-2 through 1.401(k)-6, the term plan means a plan within the meaning of §1.410(b)-7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)-7(c), and the permissive aggregation rules of §1.410(b)-7(d), as modified by paragraph (b)(4)(v) of this section. Thus, for example, two plans (within the meaning of §1.410(b)-7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)-7(d) are treated as a single plan for purposes of section 401(k) and section 401(m).

(B) Plans with inconsistent ADP testing methods. Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all cash or deferred arrangements under a plan. Thus, in applying the permissive aggregation rules of §1.410(b)-7(d), an employer may not aggregate plans (within the meaning of §1.410(b)-7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)-7(b)) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)-7(b)) using the ADP safe harbor provisions of section 401(k)(12) and another plan that is using the ADP test of section 401(k)(3).

(iv) Disaggregation of plans and separate testing--(A) In general. If a cash or deferred arrangement is included in a plan (within the meaning of §1.410(b)-7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the cash or deferred arrangement must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a cash or deferred arrangement are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(k), unless the employer is applying the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the plan. Similarly, if a cash or deferred arrangement under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the arrangement must be treated as two separate arrangements, one comprising all eligible employees who have met the age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the age and service requirements under section 410(a)(1), unless the plan is using the rule in §1.401(k)-2(a)(1)(iii)(A).

(B) Restructuring prohibited. Restructuring under §1.401(a)(4)-9(c) may not be used to demonstrate compliance with the requirements of section 401(k). See §1.401(a)(4)-9(c)(3)(ii).

(v) Modifications to section 410(b) rules--(A) Certain disaggregation rules not applicable. The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)-7(c)(1) and ESOP and non-ESOP portions of a plan set forth in §1.410(b)-7(c)(2) shall not apply for purposes of this section and §§1.401(k)-2 through 1.401(k)-6. Accordingly, notwithstanding §1.410(b)-7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of §1.410(b)-7(b)) are permitted to be aggregated for these purposes.

(B) Permissive aggregation of collective bargaining units. Notwithstanding the general rule under section 410(b) and §1.410(b)-7(c) that a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in the collective bargaining unit is treated as comprising separate plans, an employer can treat two or more separate collective bargaining units as a single collective bargaining unit for purposes of this section and §1.401(k)-2 through §1.401(k)-6, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year. Thus, for example, if a plan benefits employees in three categories (e.g., employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in any collective bargaining unit), the plan can be treated as comprising three separate plans, each of which benefits only one category of employees. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as comprising only two separate plans, one benefitting all employees who are included in a collective bargaining unit and another benefitting all other employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and employees who are included in collective bargaining unit B, the plan can be treated as comprising two separate plans. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as a single plan. An employee is treated as included in a unit of employees covered by a collective bargaining agreement if and only if the employee is a collectively bargained employee within the meaning of §1.410(b)-6(d)(2).

(C) Multiemployer plans. Notwithstanding §1.410(b)-7(c)(4)(ii)(C), the portion of the plan that is maintained pursuant to a collective bargaining agreement (within the meaning of §1.413-1(a)(2)) is treated as a single plan maintained by a single employer that employs all the employees benefitting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The rules of paragraph (b)(4)(v)(B) of this section (including the permissive aggregation of collective bargaining units) apply to the resulting deemed single plan in the same manner as they would to a single employer plan, except that the plan administrator is substituted for the employer where appropriate and appropriate fiduciary obligations are taken into account. The noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the noncollectively bargaining unit employees who benefit under the plan are employed by one or more employers.

(vi) Examples. The following examples illustrate the application of this paragraph (b)(4):

Example 1. (i) Employer A maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. For purposes of applying section 410(b), Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)-1(b). However, Employer A applies the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) to the portion of its profit-sharing plan that consists of elective contributions under the cash or deferred arrangement (and to no other plans or portions of plans).

(ii) Under these facts, the requirements of this section and §§1.401(k)-2 through 1.401(k)-6 must be applied on an employer-wide rather than a qualified separate line of business basis.

Example 2. (i) Employer B maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer B are eligible to participate. For purposes of applying section 410(b), the plan treats the cash or deferred arrangement as two separate plans, one for the employees who have completed the minimum age and service eligibility conditions under section 410(a)(1) and the other for employees who have not completed the conditions. The plan provides that it will satisfy the section 401(k) safe harbor requirement of §1.401(k)-3 with respect to the employees who have met the minimum age and service conditions and that it will meet the ADP test requirements of §1.401(k)-2 with respect to the employees who have not met the minimum age and service conditions.

(ii) Under these facts, the cash or deferred arrangement must be disaggregated on a consistent basis with the disaggregation of Plan W. Thus, the requirements of §1.401(k)-2 must be applied by comparing the ADP for eligible HCEs who have not completed the minimum age and service conditions with the ADP for eligible NHCEs for the applicable year who have not completed the minimum age and service conditions.

Example 3. (i) Employer C maintains Plan X, a stock-bonus plan including an ESOP. The plan also includes a cash or deferred arrangement for participants in the ESOP and non-ESOP portions of the plan.

(ii) Pursuant to paragraph (b)(4)(v)(A) of this section the ESOP and non-ESOP portions of the stock-bonus plan are a single cash or deferred arrangement for purposes of this section and §§1.401(k)-2 through 1.401(k)-6. However, as provided in paragraph (a)(4)(iv)(C) of this section, the ESOP and non-ESOP portions of the plan are still treated as separate plans for purposes of satisfying the requirements of section 410(b).

(c) Nonforfeitability requirements--(1) General rule. A cash or deferred arrangement satisfies this paragraph (c) only if the amount attributable to an employee's elective contributions are immediately nonforfeitable, within the meaning of paragraph (c)(2) of this section, are disregarded for purposes of applying section 411(a) to other contributions or benefits, and the contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) Definition of immediately nonforfeitable. An amount is immediately nonforfeitable if it is immediately nonforfeitable within the meaning of section 411, and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date. An amount that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(3) Example. The following example illustrates the application of this paragraph (c):

Example. (i) Employees B and C are covered by Employer Y's stock bonus plan, which includes a cash or deferred arrangement. All employees participating in the plan have a nonforfeitable right to a percentage of their account balance derived from all contributions (including elective contributions) as shown in the following table:

Years of service	Nonforfeitable percentage
Less than 1	0%
1	20%
2	40%
3	60%

4	80%
5 or more	100%

(ii) The cash or deferred arrangement does not satisfy paragraph (c) of this section because elective contributions are not immediately nonforfeitable. Thus, the cash or deferred arrangement is a nonqualified cash or deferred arrangement.

(d) Distribution limitation--(1) General rule. A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also satisfy the additional requirements of paragraphs (d)(2) through (5) of this section (to the extent applicable)--

(i) The employee's death, disability, or severance from employment;

(ii) In the case of a profit-sharing, stock bonus or rural cooperative plan, the employee's attainment of age 59½, or the employee's hardship; or

(iii) The termination of the plan.

(2) Rules applicable to distributions upon severance from employment. An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee. For example, a new employer maintains a plan with respect to an employee by continuing or assuming sponsorship of the plan or by accepting a transfer of plan assets and liabilities (within the meaning of section 414(l)) with respect to the employee).

(3) Rules applicable to hardship distributions--(i) Distribution must be on account

of hardship. A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section if and only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

(ii) Limit on maximum distributable amount--(A) General rule. A distribution on account of hardship must be limited to the maximum distributable amount. The maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions. Thus, the maximum distributable amount does not include earnings, QNECs or QMACs, unless grandfathered under paragraph (d)(3)(ii)(B) of this section.

(B) Grandfathered amounts. If the plan provides, the maximum distributable amount may be increased for amounts credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or in the case of a collectively bargained plan, the earlier of--

(1) the later of January 1, 1989, or the date on which the last of the collective bargaining agreements in effect on March 1, 1986 terminates (determined without regard to any extension thereof after February 28, 1986); or

(2) January 1, 1991) and consisting of--

(i) Income allocable to elective contributions;

(ii) Qualified nonelective contributions and allocable income; and

(iii) Qualified matching contributions and allocable income.

(iii) Immediate and heavy financial need--(A) In general. Whether an employee has an immediate and heavy financial need is to be determined based on all the relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) Deemed immediate and heavy financial need. A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for--

(1) Expenses for medical care described in section 213(d) previously incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in section 152) or necessary for these persons to obtain medical care described in section 213(d);

(2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152); or

(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.

(iv) Distribution necessary to satisfy financial need--(A) Distribution may not exceed amount of need. A distribution is treated as necessary to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the distribution is not in excess of the amount required to satisfy the financial need. For this purpose, the amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(B) No alternative means available. A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all the relevant facts and circumstances. For purposes of this paragraph (d)(3)(iv), the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee.

(C) Employer reliance on employee representation. For purposes of paragraph (d)(3)(iv)(B) of this section, an immediate and heavy financial need generally may be treated as not capable of being relieved from other resources that are reasonably available to the employee, if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved--

(1) Through reimbursement or compensation by insurance or otherwise;

(2) By liquidation of the employee's assets;

(3) By cessation of elective contributions or employee contributions under the plan;

(4) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or

(5) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(D) Employee need not take counterproductive actions. For purposes of this paragraph (d)(3)(iv), a need cannot reasonably be relieved by one of the actions described in paragraph (d)(3)(iv)(C) of this section if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(E) Distribution deemed necessary to satisfy immediate and heavy financial need. A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if each of the following requirements are satisfied--

(1) The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under the plan and

all other plans maintained by the employer; and

(2) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

(F) Definition of other plans. For purposes of paragraph (d)(3)(iv)(C)(4) and (E)(1) of this section, the phrase "plans maintained by the employer" means all qualified and nonqualified plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan (including one that is part of a cafeteria plan). In addition, for purposes of paragraph (d)(3)(iv)(E)(2) of this section, the phrase "plans maintained by the employer" also includes a stock option, stock purchase, or similar plan maintained by the employer. See §1.401(k)-6 for the continued treatment of suspended employees as eligible employees.

(v) Commissioner may expand standards. The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (see 601.601(d)(2) of this chapter), expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need.

(4) Rules applicable to distributions upon plan termination--(i) No alternative defined contribution plan. A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains an alternative defined contribution

plan. For purposes of the preceding sentence, the definition of the term "employer" contained in §1.401(k)-6 is applied as of the date of plan termination, and a plan is an alternative defined contribution plan only if it is a defined contribution plan that exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the 24-month period beginning 12 months before the termination, fewer than 2% of the employees who were eligible under the defined contribution plan that includes the cash or deferred arrangement as of the date of plan termination are eligible under the other defined contribution plan, the other plan is not an alternative defined contribution plan. In addition, a defined contribution plan is not treated as an alternative defined contribution plan if it is an employee stock ownership plan as defined in section 4975(e)(7) or 409(a), a simplified employee pension as defined in section 408(k), a SIMPLE IRA plan as defined in section 408(p), a plan or contract that satisfies the requirements of section 403(b), or a plan that satisfies the requirements of section 457.

(ii) Lump sum requirement for certain distributions. A distribution may be made under paragraph (d)(1)(iii) of this section only if it is a lump sum distribution. The term lump sum distribution has the meaning provided in section 402(e)(4)(D) (without regard to section 402(e)(4)(D)(i)(I), (II), (III) and (IV)). In addition, a lump sum distribution includes a distribution of an annuity contract from a trust that is part of a plan described in section 401(a) and which is exempt from tax under section 501(a) or an annuity plan described in 403(a).

(5) Rules applicable to all distributions--(i) Exclusive distribution rules. Amounts attributable to elective contributions may not be distributed on account of any event not

described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years. For example, if excess deferrals (and income) for an employee's taxable year are not distributed within the time prescribed in §1.402(g)-1(e)(2) or (3), the amounts may be distributed only on account of an event described in this paragraph (d). Pursuant to section 401(k)(8), the prohibition on distributions set forth in this section does not apply to a distribution of excess contributions under §1.401(k)-2(b). In addition, the prohibition on distributions set forth in this paragraph (d) does not apply to a distribution of excess annual additions pursuant to §1.415-6(b)(6)(iv).

(ii) Deemed distributions. The cost of life insurance (determined under section 72) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph (d). The making of a loan is not treated as a distribution, even if the loan is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(iii) ESOP dividend distributions. A plan does not fail to satisfy the requirements of this paragraph (d) merely by reason of a dividend distribution described in section 404(k)(2).

(iv) Limitations apply after transfer. The limitations of this paragraph (d) generally continue to apply to amounts attributable to elective contributions (including QNECs and qualified matching contributions taken into account for the ADP test under §1.401(k)-2(a)(6)) that are transferred to another qualified plan of the same or another employer.

Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in this paragraph (d). In addition, a cash or deferred arrangement fails to satisfy the limitations of this paragraph (d) if it transfers amounts to a plan that does not provide that the transferred amounts may not be distributed before the times specified in this paragraph (d). The transferor plan does not fail to comply with the preceding sentence if it reasonably concludes that the transferee plan provides that the transferred amounts may not be distributed before the times specified in this paragraph (d). What constitutes a basis for a reasonable conclusion is comparable to the rules related to acceptance of rollover distributions. See §1.401(a)(31)-1, A-14. The limitations of this paragraph (d) cease to apply after the transfer, however, if the amounts could have been distributed at the time of the transfer (other than on account of hardship), and the transfer is an elective transfer described in §1.411(d)-4, Q&A-3(b)(1). The limitations of this paragraph (d) also do not apply to amounts that have been paid in a direct rollover to the plan after being distributed by another plan.

(6) Examples. The following examples illustrate the application of this paragraph (d):

Example 1. Employer M maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the cash or deferred arrangement is a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

Example 2. (i) Employer N maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement. Plan W provides for distributions upon a participant's severance from employment, death or disability. All employees of Employer N and its wholly owned subsidiary, Employer O, are eligible to participate in Plan W. Employer N agrees to sell all issued and outstanding shares of Employer O to an unrelated entity, Employer T, effective on December 31, 2006. Following the transaction, Employer O will be a wholly owned subsidiary of Employer T. Additionally, individuals who are employed by Employer O on the effective date of the sale continue to be employed by Employer O following the sale. Following the transaction, all employees of Employer O will cease to participate in Plan W and will become eligible to participate in the cash or deferred arrangement maintained by Employer T, Plan X. No assets will be transferred from Plan W to Plan X, except in the case of a direct rollover within the meaning of section 401(a)(31).

(ii) Employer O ceases to be a member of Employer N's controlled group as a result of the sale. Therefore, employees of Employer O who participated in Plan W will have a severance from employment and are eligible to receive a distribution from Plan W.

Example 3. (i) Employer Q maintains Plan Y, a profit-sharing plan that includes a cash or deferred arrangement. Plan Y, the only plan maintained by Employer Q, does not provide for loans. However, Plan Y provides that elective contributions under the arrangement may be distributed to an eligible employee on account of hardship using the deemed immediate and heavy financial need provisions of paragraph (d)(3)(iii)(B) of this section and provisions regarding distributions necessary to satisfy financial need of paragraphs (d)(3)(iv)(A) through (D) of this section. Employee A is an eligible employee in Plan Y with an account balance of $50,000 attributable to elective contributions made by Employee A. The total amount of elective contributions made by Employee A, who has not previously received a distribution from Plan Y, is $20,000. Employee A requests a $15,000 hardship distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent child. At the time of the distribution request, the sole asset of Employee A (that is reasonably available to Employee A within the meaning of paragraph (d)(3)(iv)(B) of this section) is a savings account with an available balance of $10,000.

(ii) A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependant child is deemed to be on account of an immediate and heavy financial need of Employee A.

(iii) A distribution is treated as necessary to satisfy Employee A's immediate and heavy financial need to the extent the need may not be relieved from other resources reasonably available to Employee A. Under paragraph (d)(3)(iv)(B) of this section, Employee A's $10,000 savings account is a resource that is reasonably available to the employee and must be taken into account in determining the amount necessary to satisfy Employee A's immediate and heavy financial need. Thus, Employee A may receive a distribution of only $5,000 of his elective contributions on account of this hardship, plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 4. (i) The facts are the same as in Example 3. Employee B, another employee of Employer Q has an account balance of $25,000, attributable to Employee B's elective contributions. The total amount of elective contributions made by Employee B, who has not previously received a distribution from Plan Y, is $15,000. Employee B requests a $10,000 distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent child. Employee B makes a written representation (with respect to which Employer Q has no actual knowledge to the contrary) that the need cannot reasonably be relieved: 1) through reimbursement or compensation by insurance or otherwise; 2) by liquidation of the employee's assets; 3) by cessation of elective contributions or employee contributions under the plan; 4) by other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or 5) by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee B's dependant child is deemed to be on account of an Employee B's immediate and heavy financial need. In addition, because Employer Q can rely on Employee B's written representation, the distribution is considered necessary to satisfy Employee B's immediate and heavy financial need. Therefore, Employee B may receive a $10,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 5. (i) The facts are the same as in Example 3, except Plan Y provides for hardship distributions using the safe harbor rule of paragraph (d)(3)(iv)(E) of this section. Accordingly, Plan Y provides for a 6 month suspension of an eligible employee's elective contributions and employee contributions to the plan after the receipt of a hardship distribution by such eligible employee.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependant child is deemed to be on account of an Employee A's immediate and heavy financial need. In addition, because Employee A is not eligible for any other distribution or loan from Plan Y and Plan Y suspends Employee A's elective contributions and employee contributions following receipt of the hardship distribution, the distribution will be deemed necessary to satisfy Employee A's immediate and heavy financial need (and Employee A is not required to first liquidate his savings account). Therefore, Employee A may receive a $15,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 6. Employer R maintains a pre-ERISA money purchase pension plan that includes a cash or deferred arrangement that is not a rural cooperative plan. Elective contributions under the arrangement may be distributed to an employee on account of hardship. Under paragraph (d)(1) of this section, hardship is a permissible distribution event only in a profit-sharing, stock bonus or rural cooperative plan. Since elective contributions under the arrangement may be distributed before a permissible distribution event occurs, the cash or deferred arrangement does not satisfy this paragraph (d), and is not a qualified cash or deferred arrangement. Moreover, the plan is not a qualified plan because a money purchase pension plan may not provide for payment of benefits upon hardship. See §1.401-1(b)(1)(i).

(e) Additional requirements for qualified cash or deferred arrangements--(1) Qualified plan requirement. A cash or deferred arrangement satisfies this paragraph (e) only if the plan of which it is a part is a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan that otherwise satisfies the requirements of section 401(a) (taking into account the cash or deferred arrangement). A plan that includes a cash or deferred arrangement may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. However, except as expressly permitted under section 401(m), 410(b)(2)(A)(ii) or 416(c)(2)(A), elective contributions and matching contributions taken into account under §1.401(k)-2(a) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the contributions are made) satisfy the requirements of section 401(a).

(2) Election requirements--(i) Cash must be available. A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided the option

to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or to have the employer contribute an amount in excess of the specified cash amount to a profit-sharing plan on the employee's behalf, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(ii) Frequency of elections. A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

(3) Separate accounting requirement--(i) General rule. A cash or deferred arrangement satisfies this paragraph (e) only if the portion of an employee's benefit subject to the requirements of paragraphs (c) and (d) of this section is determined by an acceptable separate accounting between that portion and any other benefits. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts

subject to the requirements of paragraphs (c) and (d) of this section and to other accounts. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section.

(ii) Satisfaction of separate accounting requirement. The requirements of paragraph (e)(3)(i) of this section are treated as satisfied if all amounts held under a plan that includes a cash or deferred arrangement (and, if applicable, under another plan to which QNECs and QMACs are made) are subject to the requirements of paragraphs (c) and (d) of this section.

(4) Limitations on cash or deferred arrangements of state and local governments--(i) General rule. A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted after May 6, 1986, by a State or local government or political subdivision thereof, or any agency or instrumentality thereof (a governmental unit). For purposes of this paragraph (e)(4), an employer that has made a legally binding commitment to adopt a cash or deferred arrangement is treated as having adopted the arrangement on that date.

(ii) Rural cooperative plans and Indian tribal governments. This paragraph (e)(4) does not apply to a rural cooperative plan or to a plan of an employer which is an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State or tribal law which is owned in whole or in part by any of the entities in this paragraph (e)(4)(ii).

(iii) Adoption after May 6, 1986. A cash or deferred arrangement is treated as adopted after May 6, 1986, with respect to all employees of any employer that adopts the arrangement after such date.

(iv) Adoption before May 7, 1986. If a governmental unit adopted a cash or deferred arrangement before May 7, 1986, then any cash or deferred arrangement adopted by the unit at any time is treated as adopted before that date. If an employer adopted an arrangement prior to such date, all employees of the employer may participate in the arrangement.

(5) One-year eligibility requirement. A cash or deferred arrangement satisfies this paragraph (e) only if no employee is required to complete a period of service with the employer maintaining the plan extending beyond the period permitted under section 410(a)(1) (determined without regard to section 410(a)(1)(B)(i)) to be eligible to make a cash or deferred election under the arrangement.

(6) Other benefits not contingent upon elective contributions--(i) General rule. A cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not to make elective contributions under the arrangement. The preceding sentence does not apply to --

(A) Any matching contribution (as defined in §1.401(m)-1(a)(2)) made by reason of such an election;

(B) Any benefit, right or feature (such as a plan loan) that requires, or results in, an amount to be withheld from an employee's pay (e.g. to pay for the benefit or to repay the loan), to the extent the cash or deferred arrangement restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes);

(C) Any reduction in the employer's top-heavy contributions under section 416(c)(2) because of matching contributions that resulted from the elective contributions; or

(D) Any benefit that is provided at the employee's election under a plan described in section 125(d) in lieu of an elective contribution under a qualified cash or deferred arrangement.

(ii) Definition of other benefits. For purposes of this paragraph (e)(6), other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective contributions under a defined contribution plan; the availability, cost, or amount of health benefits; vacations or vacation pay; life insurance; dental plans; legal services plans; loans (including plan loans); financial planning services; subsidized retirement benefits; stock options; property subject to section 83; and dependent care assistance. Also, increases in salary and bonuses (other than those actually subject to the cash or deferred election) are benefits for purposes of this paragraph (e)(6). The ability to make after-tax employee contributions is a benefit, but that benefit is not contingent upon an employee's electing to make or not make elective contributions under the arrangement merely because the amount of elective contributions reduces dollar-for-dollar the amount of after-tax employee contributions that may be made. Additionally, benefits under any other plan or arrangement (whether or not qualified) are not contingent upon an employee's electing to make or not to make elective contributions under a cash or deferred arrangement merely because the elective contributions are or are not taken into account as compensation under the other plan or arrangement for purposes of determining benefits.

(iii) Effect of certain statutory limits. Any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of 1974 that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent.

(iv) Nonqualified deferred compensation. Participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) only to the extent that an employee may receive additional deferred compensation under the nonqualified plan to the extent the employee makes or does not make elective contributions. Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.

(v) Plan loans and distributions. A loan or distribution of elective contributions is not a benefit conditioned on an employee's electing to make or not make elective contributions under the arrangement merely because the amount of the loan or distribution is based on the amount of the employee's account balance.

(vi) Examples. The following examples illustrate the application of this paragraph (e)(6):

Example 1. Employer T maintains a cash or deferred arrangement for all of its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the nonqualified deferred compensation plan, R and C are eligible to participate only if they do not make elective contributions under the cash or deferred arrangement. Participation in the nonqualified plan is a contingent benefit for purposes of this paragraph (e)(6), because R's and C's participation is conditioned on their electing not to make elective contributions under the cash or deferred arrangement.

Example 2. Employer T maintains a cash or deferred arrangement for all its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the arrangements, Employees R and C may defer a maximum of 10% of their compensation, and may allocate their deferral between the cash or deferred arrangement and the nonqualified deferred compensation plan in any way they choose (subject to the overall 10% maximum). Because the maximum deferral available under the nonqualified deferred compensation plan depends on the elective deferrals made under the cash or deferred arrangement, the right to participate in the nonqualified plan is a contingent benefit for purposes of paragraph (e)(6).

(7) Plan provision requirement. A plan that includes a cash or deferred arrangement satisfies this paragraph (e) only if it provides that the nondiscrimination requirements of section 401(k) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1)(ii) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3), as described in paragraph (b)(1)(ii)(A) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the ADP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(k)(12), as described in paragraph (b)(1)(ii)(B) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (e)(7), a plan may incorporate by reference the provisions of section 401(k)(3) and §1.401(k)-2 if that is the

nondiscrimination test being applied.

(f) Effective dates--(1) General rule. This section and §§1.401(k)-2 through 1.401(k)-6 apply to plan years that begin on or after the date that is 12 months after the issuance of these regulations in final form, except as otherwise provided in this paragraph (f).

(2) Collectively bargained plans. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers in effect on the date described in paragraph (f)(1) of this section, the provisions of this section and §§1.401(k)-2 through 1.401(k)-6 apply to the later of the first plan year beginning after the termination of the last such agreement or the plan year described in paragraph (f)(1) of this section.

§1.401(k)-2 ADP test.

(a) Actual deferral percentage (ADP) test--(1) In general--(i) ADP test formula. A cash or deferred arrangement satisfies the ADP test for a plan year only if--

(A) The ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ADP for the eligible HCEs for the plan year over the ADP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) HCEs as sole eligible employees. If, for the applicable year for determining the ADP of the NHCEs for a plan year, there are no eligible NHCEs (i.e, all of the eligible employees under the cash or deferred arrangement for the applicable year are

HCEs), the arrangement is deemed to satisfy the ADP test for the plan year.

(iii) Special rule for early participation. If a cash or deferred arrangement provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the cash or deferred arrangement meets the requirements of section 410(b)(1), then in determining whether the arrangement meets the requirements under paragraph (a)(1) of this section, either--

(A) Pursuant to section 401(k)(3)(F), the ADP test is performed under the plan (determined without regard to disaggregation under §1.410(b)-7(c)(3)), using the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(k)-1(b)(4), the plan is disaggregated into separate plans and the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) Determination of ADP--(i) General rule. The ADP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ADRs of the eligible employees in that group for that year. The ADP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) Determination of applicable year under current year and prior year testing method. The ADP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ADP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ADP test is being performed. Under the prior year testing method, the ADP for the eligible NHCEs is determined using the ADRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ADP test is being calculated. Under the current year testing method, the applicable year for determining the ADP for the eligible NHCEs is the same plan year as the plan year for which the ADP test is being performed. Under either method, the ADP for eligible HCEs is the average of the ADRs of the eligible HCEs for the plan year for which the ADP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) Determination of ADR--(i) General rule. The ADR of an eligible employee for a plan year or applicable year is the sum of the employee's elective contributions taken into account with respect to such employee for the year, determined under the rules of paragraphs (a)(4) and (5) of this section, and the qualified nonelective contributions and qualified matching contributions taken into account with respect to such employee under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ADR is calculated to the nearest hundredth of a percentage point. If no elective contributions, qualified nonelective contributions, or qualified matching contributions are taken into account under this section with respect to an eligible employee for the year, the ADR of the employee is zero.

(ii) ADR of HCEs eligible under more than one arrangement--(A) General rule. Pursuant to section 401(k)(3)(A), the ADR of an HCE who is an eligible employee in more than one cash or deferred arrangement of the same employer is calculated by treating all contributions with respect to such HCE under any such arrangement as being made under the cash or deferred arrangement being tested. Thus, the ADR for such an HCE is calculated by accumulating all contributions under any cash or deferred arrangement (other than a cash or deferred arrangement described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the cash or deferred arrangement under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ADR for the plan year of that plan for an HCE who participates in multiple cash or deferred arrangements of the same employer is the sum of all contributions during such 12-month period that would be taken into account with respect to the HCE under all such arrangements in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(k)-3.

(B) Plans not permitted to be aggregated. Cash or deferred arrangements under plans that are not permitted to be aggregated under §1.401(k)-1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(k)-1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)-7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) Examples. The following examples illustrate the application of this paragraph (a)(3):

Example 1. (i) Employee A, an HCE with compensation of $120,000, is eligible to make elective contributions under Plan S and Plan T, two profit-sharing plans maintained by Employer H with calendar year plan years, each of which includes a cash or deferred arrangement. During the current plan year, Employee A makes elective contributions of $6,000 to Plan S and $4,000 to Plan T.

(ii) Under each plan, the ADR for Employee A is determined by dividing Employee A's total elective contributions under both arrangements by Employee A's compensation taken into account under the plan for the year. Therefore, Employee A's ADR under each plan is 8.33% ($10,000/$120,000).

Example 2. (i) The facts are the same as in Example 1, except that Plan T defines compensation (for deferral and testing purposes) to exclude all bonuses paid to an employee. Plan S defines compensation (for deferral and testing purposes) to include bonuses paid to an employee. During the current year, Employee A's compensation included a $10,000 bonus. Therefore, Employee A's compensation under Plan T is $110,000 and Employee A's compensation under Plan S is $120,000.

(ii) Employee A's ADR under Plan T is 9.09% ($10,000/$110,000) and under Plan S, Employee A's ADR is 8.33% ($10,000/$120,000).

Example 3. (i) Employer J sponsors two profit-sharing plans, Plan U and Plan V, each of which includes a cash or deferred arrangement. Plan U's plan year begins on July 1 and ends on June 30. Plan V has a calendar year plan year. Compensation under both plans is limited to the participant's compensation during the period of participation. Employee B is an HCE who participates in both plans. Employee B's monthly compensation and elective contributions to each plan for the 2005 and 2006 calendar years are as follows:

Calendar year	Monthly Compensation	Monthly Elective Contribution to Plan U	Monthly Elective Contribution to Plan V
2005	$10,000	$500	$400
2006	$11,500	$700	$550

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and Plan V for the plan year ending June 30, 2006 divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is (($900 x 6) + ($1,250 x 6)) / (($10,000 x 6) + ($11,500 x 6)), or 10%.

(iii) Under Plan V, Employee B's ADR for the plan year ended December 31, 2005, is equal to total elective contributions under Plan U and V for the plan year ending December 31, 2005, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan V for the plan year ending December 31, 2005, is ($10,800/$120,000), or 9%.

Example 4. (i) The facts are the same as Example 3, except that Employee B first becomes eligible to participate in Plan U on January 1, 2006.

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is (($400 x 6)+ ($1,250 x 6)) / (($10,000 x 6) + ($11,500 x 6)), or 7.67%.

(4) Elective contributions taken into account under the ADP test--(i) General rule. An elective contribution is taken into account in determining the ADR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied:

(A) The elective contribution is allocated to the eligible employee's account under the plan as of a date within that year. For purposes of this rule, an elective contribution is considered allocated as of a date within a year only if--

(1) The allocation is not contingent on the employee's participation in the plan or performance of services on any date subsequent to that date; and

(2) The elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year to which the contribution relates.

(B) The elective contribution relates to compensation that either--

(1) Would have been received by the employee in the year but for the

employee's election to defer under the arrangement; or

(2) Is attributable to services performed by the employee in the year and, but for the employee's election to defer, would have been received by the employee within 2½ months after the close of the year, but only if the plan so provides for elective contributions that relate to compensation that would have been received after the close of a year to be allocated to such prior year rather than the year in which the compensation would have been received.

(ii) Elective contributions for partners and self-employed individuals. For purposes of this paragraph (a)(4), a partner's distributive share of partnership income is treated as received on the last day of the partnership taxable year and a sole proprietor's compensation is treated as received on the last day of the individual's taxable year. Thus, an elective contribution made on behalf of a partner or sole proprietor is treated as allocated to the partner's account for the plan year that includes the last day of the partnership taxable year, provided the requirements of paragraph (a)(4)(i) of this section are met.

(iii) Elective contributions for HCEs. Elective contributions of an HCE must include any excess deferrals, as described in §1.402(g)-1(a), even if those excess deferrals are distributed, pursuant to §1.402(g)-1(e).

(5) Elective contributions not taken into account under the ADP test--(i) General rule. Elective contributions that do not satisfy the requirements of paragraph (a)(4)(i) of this section may not be taken into account in determining the ADR of an eligible employee for the plan year or applicable year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the elective contributions

must satisfy the requirements of section 401(a)(4) (without regard to the ADP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. See §§1.401(a)(4)-1(b)(2)(ii)(B) and 1.410(b)-7(c)(1).

(ii) Elective contributions for NHCEs. Elective contributions of an NHCE shall not include any excess deferrals, as described in §1.402(g)-1(a), to the extent the excess deferrals are prohibited under section 401(a)(30). However, to the extent that the excess deferrals are not prohibited under section 401(a)(30), they are included in elective contributions even if distributed pursuant to §1.402(g)-1(e).

(iii) Elective contributions treated as catch-up contributions. Elective contributions that are treated as catch-up contributions under section 414(v) because they exceed a statutory limit or employer-provided limit (within the meaning of §1.414(v)-1(b)(1)) are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions were made, or for any other plan year.

(iv) Elective contributions used to satisfy the ACP test. Except to the extent necessary to demonstrate satisfaction of the requirement of §1.401(m)-2(a)(6)(ii), elective contributions taken into account for the ACP test under §1.401(m)-2(a)(6) are not taken into account under paragraph (a)(4) of this section.

(6) Qualified nonelective contributions and qualified matching contributions that may be taken into account under the ADP test. Qualified nonelective contributions and qualified matching contributions may be taken into account in determining the ADR for an eligible employee for a plan year or applicable year but only to the extent the contributions satisfy the following requirements.

(i) Timing of allocation. The qualified nonelective contribution or qualified matching contribution is allocated to the employee's account as of a date within that year within the meaning of paragraph (a)(4)(i)(A) of this section. Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP for the eligible NHCEs for the applicable year, a qualified nonelective contribution or qualified matching contribution must be contributed no later than the end of the 12-month period immediately following the applicable year even though the applicable year is different than the plan year being tested.

(ii) Requirement that amount satisfy section 401(a)(4). The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under §1.401(m)-2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)-1(b)(2). The amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under §1.401(m)-2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)-1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the cash or deferred arrangement, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the cash or deferred arrangement, then the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iii) Aggregation must be permitted. The plan that contains the cash or deferred arrangement and the plan or plans to which the qualified nonelective contributions or qualified matching contributions are made, are plans that would be permitted to be aggregated under §1.401(k)-1(b)(4). If the plan year of the plan that contains the cash or deferred arrangement is changed to satisfy the requirement under §1.410(b)-7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if such qualified nonelective contributions and qualified matching contributions could have been taken into account under an ADP test for a plan with the same short plan year.

(iv) Disproportionate contributions not taken into account--(A) General rule. Qualified nonelective contributions cannot be taken into account for a plan year for an NHCE to the extent such contributions exceed the product of that NHCE's compensation and the greater of 5% or two times the plan's representative contribution rate. Any qualified nonelective contribution taken into account under an ACP test under §1.401(m)-2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(m)-2(a)(6)(v)(B)), is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate under paragraph (a)(6)(iv)(B) of this section).

(B) Definition of representative contribution rate. For purposes of this paragraph (a)(6)(iv), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the plan year and who is employed by the employer on the last day of the plan year).

(C) Definition of applicable contribution rate. For purposes of this paragraph (a)(6)(iv), the applicable contribution rate for an eligible NHCE is the sum of the qualified matching contributions taken into account under this paragraph (a)(6) for the eligible NHCE for the plan year and the qualified nonelective contributions made for that eligible NHCE for the plan year, divided by that eligible NHCE's compensation for the same period.

(v) Qualified matching contributions. Qualified matching contributions satisfy this paragraph (a)(6) only to the extent that such qualified matching contributions are matching contributions that are not precluded from being taken into account under the ACP test for the plan year under the rules of §1.401(m)-2(a)(5)(ii).

(vi) Contributions only used once. Qualified nonelective contributions and qualified matching contributions can not be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ADP test, any ACP test, or the requirements of §1.401(k)-3, 1.401(m)-3 or 1.401(k)-4. Thus, for example, matching contributions that are made pursuant to

§1.401(k)-3(c) cannot be taken into account under the ADP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(k)-2(c), qualified nonelective contributions that are taken into account under the current year testing method for a year may not be taken into account under the prior year testing method for the next year

(7) Examples. The following examples illustrate the application of this paragraph (a):

Example 1. (i) Employer X has three employees, A, B, and C. Employer X sponsors a profit-sharing plan (Plan Z) that includes a cash or deferred arrangement. Each year, Employer X determines a bonus attributable to the prior year. Under the cash or deferred arrangement, each eligible employee may elect to receive none, all or any part of the bonus in cash. X contributes the remainder to Plan Z. The portion of the bonus paid in cash, if any, is paid 2 months after the end of the plan year and thus is included in compensation for the following plan year. Employee A is an HCE, while Employees B and C are NHCEs. The plan uses the current year testing method and defines compensation to include elective contributions and bonuses paid during each plan year. In February of 2005, Employer X determined that no bonuses will be paid for 2004. In February of 2006, Employer X provided a bonus for each employee equal to 10% of regular compensation for 2005. For the 2005 plan year, A, B, and C have the following compensation and make the following elections:

Employee	Compensation	Elective Contribution
A	$100,000	$4,340
B	60,000	2,860
C	45,000	1,250

(ii) For each employee, the ratio of elective contributions to the employee's compensation for the plan year is:

Employee	Ratio of Elective Contribution to Compensation	ADR
A	$4,340/$100,000	4.34%
B	2,860/60,000	4.77

C	1,250/45,000	2.78

(iii) The ADP for the HCEs (Employee A) is 4.34%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 4.34% is less than 4.73% (3.78% multiplied by 1.25), the plan satisfies the ADP test under paragraph (a)(1)(i) of this section.

Example 2. (i) The facts are the same as in Example 1, except that elective contributions are made pursuant to a salary reduction agreement throughout the plan year, and no bonuses are paid. As provided by section 414(s)(2), Employer X includes elective contributions in compensation. During the year, B and C defer the same amount as in Example 1, but A defers $5,770. Thus, the compensation and elective contributions for A, B, and C are:

Employee	Gross Compensation	Elective Contributions	ADR
A	$ 100,000	$ 5,770	5.77%
B	60,000	2,860	4.77
C	45,000	1,250	2.78

(ii) The ADP for the HCEs (Employee A) is 5.77 %. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 5.77% exceeds 4.73% (3.78% x 1.25), the plan does not satisfy the ADP test under paragraph (a)(1)(i) of this section. However, because the ADP for the HCEs does not exceed the ADP for the NHCEs by more than 2 percentage points and the ADP for the HCEs does not exceed the ADP for the NHCEs multiplied by 2 (3.78% x 2 = 7.56%), the plan satisfies the ADP test under paragraph (a)(1)(ii) of this section.

Example 3. (i) Employees D through L are eligible employees in Plan T, a profit-sharing plan that contains a cash or deferred arrangement. The plan is a calendar year plan that uses the prior year testing method. Plan T provides that elective contributions are included in compensation (as provided under section 414(s)(2)). Each eligible employee may elect to defer up to 6% of compensation under the cash or deferred arrangement. Employees D and E are HCEs. The compensation, elective contributions, and ADRs of Employees D and E for the 2006 plan year are shown below:

Employee	Compensation for 2006 Plan Year	Elective Contributions for 2006 Plan Year	ADR for 2006 Plan Year
D	$100,000	$10,000	10%
E	$95,000	$4,750	5%

(ii) During the 2005 plan year, Employees F through L were eligible NHCEs. The compensation, elective contributions and ADRs of Employees F through L for the 2005 plan year are shown in the following table:

Employee	Compensation for 2005 Plan Year	Elective Contributions for 2005 Plan Year	ADR for 2005 Plan Year
F	$60,000	$3,600	6%
G	$40,000	$1,600	4%
H	$30,000	$1,200	4%
I	$20,000	$ 600	3%
J	$20,000	$600	3%
K	$10,000	$300	3%
L	$5,000	$150	3%

(iii) The ADP for 2006 for the HCEs is 7.5%. Because Plan T is using the prior year testing method, the applicable year for determining the NHCE ADP is the prior plan year (i.e., 2005). The NHCE ADP is determined using the ADRs for NHCEs eligible during the prior plan year (without regard to whether they are eligible under the plan during the plan year). The ADP for the NHCEs is 3.71% (the sum of the individual ADRs, 26%, divided by 7 employees). Because 7.5% exceeds 4.64% (3.71% x 1.25), Plan T does not satisfy the ADP test under paragraph (a)(1)(i) of this section. In addition, because the ADP for the HCEs exceeds the ADP for the NHCEs by more than 2 percentage points, Plan T does not satisfy the ADP test under paragraph (a)(1)(ii) of this section. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 4. (i) Plan U is a calendar year profit-sharing plan that contains a cash or deferred arrangement and uses the current year testing method. Plan U provides that elective contributions are included in compensation (as provided under section 414(s)(2)). The following amounts are contributed under Plan U for the 2006 plan year: (A) QNECs equal to 2% of each employee's compensation; (B) Contributions equal to 6% of each employee's compensation that are not immediately vested under the terms of the plan; (C) 3% of each employee's compensation that the employee may elect to receive as cash or to defer under the plan. Both types of nonelective contributions are made for the HCEs (employees M and N) and the NHCEs (employees O through S) for the plan year and are contributed after the end of the plan year and before the end of the following plan year. In addition, neither type of nonelective contributions is used for any other ADP or ACP test.

(ii) For the 2006 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S are shown in the following table:

Employee	Compensation	Elective Contributions	Actual Deferral Ratio
M	$100,000	$3,000	3%
N	$100,000	$2,000	2%
O	$ 60,000	$1,800	3%
P	$40,000	0	0
Q	$30,000	0	0
R	$5,000	0	0
S	$20,000	0	0

(iii) The elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section because the ADP for the HCEs, consisting of employees M and N, is 2.5% and the ADP for the NHCEs is 0.6%.

(iv) The 2% QNECs satisfies the timing requirement of paragraph (a)(6)(i) of this section because it is paid within 12-month after the plan year for which allocated. All nonelective contributions also satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section (because all employees receive an 8% nonelective contribution and the nonelective contributions excluding the QNECs is 6% for all employees). In addition, the QNECs are not disproportionate under paragraph (a)(6)(iv) of this section because no QNEC for an NHCE exceeds the product of the plan's applicable contribution rate (2%) and that NHCE's compensation.

(v) Because the rules of paragraph (a)(6) of this section are satisfied, the 2% QNECs may be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section. The 6% nonelective contributions, however, may not be taken into account because they are not QNECs.

(vi) If the 2% QNECs are taken into account, the ADP for the HCEs is 4.5%, and the actual deferral percentage for the NHCEs is 2.6%. Because 4.5% is not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the cash or deferred arrangement satisfies the ADP test of section 401(k)(3) under paragraph (a)(1)(ii) of this section.

Example 5. (i) The facts are the same as Example 4, except the plan uses the prior year testing method. In addition, the NHCE ADP for the 2005 plan year (the prior plan year) is 0.8% and no QNECs are contributed for the 2005 plan year during 2005 or 2006.

(ii) In 2007, it is determined that the elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for 2006 because the 2006 ADP for the eligible HCEs, consisting of employees M and N, is 2.5% and the 2005 ADP for the eligible NHCEs is 0.8%. An additional QNEC of 2% of compensation is made for each eligible NHCE in 2007 and allocated for 2005.

(iii) The 2% QNECs that are made in 2007 and allocated for the 2005 plan year do not satisfy the timing requirement of paragraph (a)(6)(i) of this section for the applicable year for the 2005 plan year because they were not contributed before the last day of the 2006 plan year. Accordingly, the 2% QNECs do not satisfy the rules of paragraph (a)(6) of this section and may not be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for the 2006 plan year. The cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 6. (i) The facts are the same as Example 4, except that the ADP for the HCEs is 4.6% and there is no 6% nonelective contribution under the plan. The employer would like to take into account the 2% QNEC in determining the ADP for the NHCEs but not in determining the ADP for the HCEs.

(ii) The elective contributions alone fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (4.6%) exceeds 0.75% (0.6% x 1.25) and 1.2% (0.6% x 2).

(iii) The 2% QNECs may not be taken into account in determining the ADP of the NHCEs because they fail to satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section. This is because the amount of nonelective contributions, excluding those QNECs that would be taken into account under the ADP test, would be 2% of compensation for the HCEs and 0% for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 7. (i) The facts are the same as Example 6, except that Employee R receives a QNEC in an amount of $500 and no QNECs are made on behalf of the other employees.

(ii) If the QNEC could be taken into account under paragraph (a)(6) of this section, the ADP for the NHCEs would be 2.6% and the plan would satisfy the ADP test. The QNEC is disproportionate under paragraph (a)(6)(iv) of this section, and cannot be taken into account under paragraph (a)(6) of this section, to the extent it exceeds the greater of 5% and two times the plan's representative contribution rate (0%), multiplied by Employee R's compensation. The plan's representative contribution rate is 0% because it is the lowest applicable contribution rate among a group of NHCEs that is at least half of all NHCEs, or all the NHCEs who are employed on the last day of the plan year. Therefore, the QNEC may be taken into account under the ADP test only to the extent it does not exceed 5% times Employee R's compensation (or $250) and the cash or deferred arrangement fails to satisfy the ADP test and must correct under paragraph (b) of this section.

Example 8. (i) The facts are the same as in Example 4 except that the plan changes from the current year testing method to the prior year testing method for the following plan year (2006 plan year). The ADP for the HCEs for the 2006 plan year is 3.5%.

(ii) The 2% QNECs may not be taken into account in determining the ADP for the NHCEs for the applicable year (2005 plan year) in satisfying the ADP test for the 2006 plan year because they were taken into account in satisfying the ADP test for the 2005 plan year. Accordingly, the NHCE ADP for the applicable year is 0.6%. The elective contributions for the plan year fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (3.5%) exceeds the ADP limit of 1.2% (the greater of 0.75% (0.6% x 1.25) and 1.2% (0.6% x 2)), determined using the applicable year ADP for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 9. (i)(A) Employer N maintains Plan X, a profit sharing plan that contains a cash or deferred arrangement and that uses the current year testing method. Plan X provides for employee contributions, elective contributions, and matching contributions. Matching contributions on behalf of nonhighly compensated employees are qualified matching contributions (QMACs) and are contributed during the 2005 plan year. Matching contributions on behalf of highly compensated employees are not QMACs, because they fail to satisfy the nonforfeitability requirement of §1.401(k)-1(c). The elective contributions and matching contributions with respect to HCEs for the 2005 plan year are shown in the following table:

	Elective Contributions	Total Matching Contributions	Matching contributions that are not QMACs	QMACs
Highly compensated employees	15%	5%	5%	0%

(B) The elective contributions and matching contributions with respect to the NHCEs for the 2005 plan year are shown in the following table:

	Elective Contributions	Total Matching Contributions	Matching contributions that are not QMACs	QMACs
Nonhighly compensated employees	11%	4%	0%	4%

(ii) The plan fails to satisfy the ADP test of section 401(k)(3)(A) and paragraph (a)(1) of this section because the ADP for HCEs (15%) is more than 125% of the ADP for NHCEs (11%), and more than 2 percentage points greater than 11%. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) provided that they are not used for any other ADP or ACP test. QMACs equal to 1% of compensation are taken into account for each NHCE in applying the ADP test. After this adjustment, the applicable ADP and ACP (taking into account the provisions of §1.401(m)-2(a)(5)(ii)) for the plan year are as follows:

	Actual Deferral Percentage	Actual Contribution Percentage
HCEs	15%	5%
Nonhighly compensated employees	12	3

(iii) The elective contributions and QMACs taken into account for purposes of the ADP test of section 401(k)(3) satisfy the requirements of section 401(k)(3)(A)(ii) under paragraph (a)(1)(ii) of this section because the ADP for HCEs (15%) is not more than the ADP for NHCEs multiplied by 1.25 (12% x 1.25 = 15%).

(b) Correction of excess contributions--(1) Permissible correction methods--(i) In general. A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement, uses any of the following correction methods--

(A) Qualified nonelective contributions or qualified matching contributions. The employer makes qualified nonelective contributions or qualified matching contributions that are taken into account under this section and, in combination with other amounts taken into account under paragraph (a) of this section, allow the cash or deferred arrangement to satisfy the requirements of paragraph (a)(1) of this section.

(B) Excess contributions distributed. Excess contributions are distributed in accordance with paragraph (b)(2) of this section.

(C) Excess contributions recharacterized. Excess contributions are recharacterized in accordance with paragraph (b)(3) of this section.

(ii) Combination of correction methods. A plan may provide for the use of any of the correction methods described in paragraph (b)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. A plan may require or permit an HCE to elect whether any excess contributions are to be recharacterized or distributed. If the plan uses a combination of correction methods, any contribution made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction methods in paragraph (b)(1)(i)(B) or (C) of this section. (iii) Exclusive means of correction. A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than the ones described in paragraphs (b)(1)(i) and (ii) of this section. Thus, excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)-11(g). See §1.401(a)(4)-11(g)(3)(vii) and (5).

(2) Corrections through distribution--(i) General rule. This paragraph (b)(2)

contains the rules for correction of excess contributions through a distribution from the plan. Correction through a distribution generally involves a 4 step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess contributions among HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned excess contributions and allocable income in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions. Paragraph (b)(2)(vii) provides other rules relating to these distributions.

(ii) Calculation of total amount to be distributed. The following procedures must be used to determine the total amount of the excess contributions to be distributed--

(A) Calculate the dollar amount of excess contributions for each HCE. The amount of excess contributions attributable to a given HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ADR to equal the highest permitted ADR under the plan. To calculate the highest permitted ADR under a plan, the ADR of the HCE with the highest ADR is reduced by the amount required to cause that HCE's ADR to equal the ADR of the HCE with the next highest ADR. If a lesser reduction would enable the arrangement to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction is used in determining the highest permitted ADR.

(B) Determination of the total amount of excess contributions. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the arrangement would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess contributions for the plan year.

(C) Satisfaction of ADP. A cash or deferred arrangement satisfies this paragraph (b)(2)(ii)(C) if the arrangement would satisfy the requirements of paragraph (a)(1)(ii) of this section if the ADR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) Apportionment of total amount of excess contributions among the HCEs. The following procedures must be used in apportioning the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section among the HCEs:

(A) Calculate the dollar amount of excess contributions for each HCE. The contributions of the HCE with the highest dollar amount of contributions taken into account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of the contributions taken into account under this section for the HCE with the next highest dollar amount of contributions taken account under this section. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess contributions, only the lesser apportionment would apply.

(B) Limit on amount apportioned to any individual. For purposes of this paragraph (b)(2)(iii), the amount of contributions taken into account under this section with respect to an HCE who is an eligible employee in more than one plan of an employer is determined by taking into account all contributions otherwise taken into account with respect to such HCE under any plan of the employer during the plan year of the plan being tested as being made under the plan being tested. However, the amount of excess contributions apportioned for a plan year with respect to any HCE must not exceed the amount of contributions actually contributed to the plan for the HCE for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which elective contributions are made and whose ADR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount required to be distributed under this paragraph (b)(2)(iii) shall not exceed the contributions actually contributed to the plan and taken into account under this section for the plan year.

(C) Apportionment to additional HCEs. The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section have been apportioned.

(iv) Income allocable to excess contributions--(A) General rule. The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess contributions are or will be credited with allocable gain or loss for the period after the close of the plan year (gap period), the allocable gain or loss for the gap period.

(B) Method of allocating income. A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participant's accounts. See §1.401(a)(4)-1(c)(8).

(C) Alternative method of allocating plan year income. A plan may allocate income to excess contributions for the plan year by multiplying the income for the plan year allocable to the elective contributions and other amounts taken account under this section (including contributions made for the plan year), by a fraction, the numerator of which is the excess contributions for the employee for the plan year, and the denominator of which is the account balance attributable to elective contributions and other contributions taken into account under this section as of the beginning of the plan year (including any additional amount of such contributions made for the plan year).

(D) Safe harbor method of allocating gap period income. A plan may use the safe harbor method in this paragraph (b)(2)(iv)(D) to determine income on excess contributions for the gap period. Under this safe harbor method, income on excess contributions for the gap period is equal to 10% of the income allocable to excess contributions for the plan year that would be determined under paragraph (b)(2)(iv)(C) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.

(E) Alternative method for allocating plan year and gap period income. A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to this aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken account under this section for the plan year in determining the fraction that is multiplied by that income.

(v) Distribution. Within 12 months after the close of the plan year in which the excess contribution arose, the plan must distribute to each HCE the excess contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section and the allocable income. Except as otherwise provided in this paragraph (b)(2)(v) and paragraph (b)(4)(i) of this section, a distribution of excess contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of an HCE is distributed prior to when the plan makes a distribution of excess contributions in accordance with this paragraph (b)(2), the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(vi) Tax treatment of corrective distributions--(A) General rule. Except as provided in paragraph (b)(2)(vi)(B) of this section, a corrective distribution of excess contributions (and income) that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the earliest date any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t). See paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year. See also §1.402(c)-2, A-4 for restrictions on rolling over distributions that are excess contributions.

(B) Rule for de minimis distributions. If the total amount of excess contributions, determined under this paragraph (b)(2), and excess aggregate contributions determined under §1.401(m)-2(b)(2) distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess contributions (and income) is includible in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(vii) Other rules--(A) No employee or spousal consent required. A corrective distribution of excess contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(B) Treatment of corrective distributions as elective contributions. Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(C) No reduction of required minimum distribution. A distribution of excess contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9). See §1.401(a)(9)-5, Q&A-9(b).

(D) Partial distributions. Any distribution of less than the entire amount of excess contributions (and allocable income) with respect to any HCE is treated as a pro rata distribution of excess contributions and allocable income.

(viii) Examples. The following examples illustrate the application of this paragraph (b)(2). For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

Example 1. (i) Plan P, a calendar year profit-sharing plan that includes a cash or deferred arrangement, provides for distribution of excess contributions to HCEs to the extent necessary to satisfy the ADP test. Employee A, an HCE, has elective contributions of $12,000 and $200,000 in compensation, for an ADR of 6%, and Employee B, a second HCE, has elective contributions of $8,960 and compensation of $128,000, for an ADR of 7%. The ADP for the NHCEs is 3%. Under the ADP test, the ADP of the two HCEs under the plan may not exceed 5% (i.e., 2 percentage points more than the ADP of the NHCEs under the plan). The ADP for the 2 HCEs under the plan is 6.5%. Therefore, there must be a correction of excess contributions.

(ii) The total amount of excess contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the elective contributions of Employee B (the HCE with the highest ADR) are reduced by $1,280 in order to reduce his ADR to 6% ($7,680/$128,000), which is the ADR of Employee A.

(iii) Because the ADP of the HCEs determined after the $1,280 reduction to Employee B still exceeds 5%, further reductions in elective contributions are necessary in order to reduce the ADP of the HCEs to 5%. The elective contributions of Employee A and Employee B are each reduced by 1% of compensation ($2,000 and $1,280 respectively). Because the ADP of the HCEs determined after the reductions equals 5%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess contributions ($4,560 = $1,280+$2,000+$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. Therefore, Employee A is apportioned $3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions).

(v) Because the total amount of excess contributions has not been apportioned, further apportionment is necessary. The balance ($1,520) of the total amount of excess contributions is apportioned equally among Employee A and Employee B ($760 to each).

(vi) Therefore, the cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to $3,800 ($3,040 + $760) and allocable income and Employee B receives a corrective distribution of $760 and allocable income.

Example 2. (i) The facts are the same as in Example 1, except Employee A's ADR is based on $3,000 of elective contributions to this plan and $9,000 of elective contributions to another plan of the employer.

(ii) The total amount of excess contributions ($4,560 = $1,280+$2,000+$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. The amount of elective contributions for Employee A is $12,000. Therefore, Employee A is apportioned $3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions). However, pursuant to paragraph (b)(2)(iii)(B) of this section, no more than the amount actually contributed to the plan may be apportioned to an HCE. Accordingly, no more than $3,000 may be apportioned to Employee A. Therefore, the remaining $1,560 must be apportioned to Employee B.

(ii) The cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to $3,000 (total amount of elective contributions actually contributed to the plan for Employee A) and allocable income and Employee B receives a corrective distribution of $1,560 and allocable income.

Example 3. (i) The facts are the same as in Example 1. The plan allocates income on a daily basis. The corrective distributions are made in February 2007. The excess contribution that must be distributed to Employee A as a corrective distribution is $3,800. This amount must be increased (or decreased) to reflect gains (or losses) allocable to that amount during the 2006 plan year. The plan uses a reasonable method that satisfies paragraph (b)(2)(iv)(B) of this section to determine the gain during the 2006 plan year allocable to the $3,800 as $145. Therefore, as of the end of the 2006 plan year, the amount of corrective distribution that is required would be $3,945.

(ii) Because the plan allocates income on a daily basis, excess contributions are credited with gain or loss during the gap period. Therefore, the corrective distribution must include income allocable to $3,945 through the date of distribution. For the period from January 1 through the date of distribution, the income allocable to $3,945 is $105. Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if Employee A receives a corrective distribution of $4,050.

Example 4. (i) The facts are the same as in Example 1. The plan determines plan year income using the alternative method for calculating income provided in paragraph (b)(2)(iv)(C) of this section and using the portion of the participant's account attributable to elective contributions, including elective contributions made for the plan year. The plan uses the safe harbor method provided in paragraph (b)(2)(iv)(D) of this section for allocating gap period income. The corrective distribution is made during the last week of February 2007. At the beginning of the 2006 plan year, $100,000 of Employee A's plan account was attributable to elective contributions. During the 2006 plan year, $10,000 in elective contributions were contributed to the plan for Employee A. The income allocable to Employee A's account attributable to elective contributions for the 2006 plan year is $8,000.

(ii) Therefore, the plan year income allocable to the $3,800 corrective distribution for Employee A is $266.65 ($8,000 multiplied by $3,800 divided by $110,000). Therefore, as of the end of the 2006 plan year, the amount of corrective distribution that is required is $4,066.65. This amount must be increased by the gap period income of $53.32 (10% multiplied by $266.65 (2006 plan year income attributable to the excess contribution) multiplied by 2 (number of calendar months since end of 2006 plan year). Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if Employee A receives a corrective distribution of $4,119.97.

Example 5. (i) The facts are the same as in Example 4, except that the plan provides for quarterly valuations based on the account balance at the end of the quarter.

(ii) Because the plan's method for allocating income does not allocate any income to amounts distributed during the quarter, Employee A will not be credited with an allocation of income with respect to the amount distributed. Accordingly, Plan P need not plan adjust the distribution of excess contribution for income during the gap period and thus satisfies paragraph (a)(1) of this section if Employee A receives a corrective distribution of $4,066.65.

(3) Recharacterization of excess contributions--(i) General rule. Excess contributions are recharacterized in accordance with this paragraph (b)(3) only if the excess contributions that would have to be distributed under (b)(2) of this section if the plan was correcting through distribution of excess contributions are recharacterized as

described in paragraph (b)(3)(ii) of this section, and all of the conditions set forth in paragraph (b)(3)(iii) of this section are satisfied.

(ii) Treatment of recharacterized excess contributions. Recharacterized excess contributions are includible in the employee's gross income as if such amounts were distributed under paragraph (b)(2) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, sections 401(a)(4) and 401(m). This requirement is not treated as satisfied unless the payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by timely providing such Federal tax forms and accompanying instructions and timely taking such other action as prescribed by the Commissioner in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin (see 601.601(d)(2) of this chapter) as well as the applicable federal tax forms and accompanying instructions.

(iii) Additional rules--(A) Time of recharacterization. Excess contributions may not be recharacterized under this paragraph (b)(3) after 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those HCEs with excess contributions to be recharacterized is notified in accordance with paragraph (b)(3)(ii) of this section.

(B) Employee contributions must be permitted under plan. The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the HCE, may not exceed the maximum amount of employee contributions (determined without regard to the ACP test of section 401(m)(2)) permitted under the provisions of the plan as in effect on the first day of the plan year.

(C) Treatment of recharacterized excess contributions. Recharacterized excess contributions continue to be treated as employer contributions for all other purposes under the Internal Revenue Code, including sections 401(a) (other than sections 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of §1.401(k)-1(c) and (d); must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and §1.415-6(b).

(4) Rules applicable to all corrections--(i) Coordination with distribution of excess deferrals--(A) Treatment of excess deferrals that reduce excess contributions. The amount of excess contributions (and allocable income) to be distributed under paragraph (b)(2) of this section or the amount of excess contributions recharacterized under paragraph (b)(3) of this section with respect to an employee for a plan year, is reduced by any amounts previously distributed to the employee from the plan to correct excess deferrals for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) Treatment of excess contributions that reduce excess deferrals. Under §1.402(g)-1(e), the amount required to be distributed to correct an excess deferral to an employee for a taxable year is reduced by any excess contributions (and allocable income) previously distributed or excess contributions recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payer or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under

§1.402(g)-1(e)(6).

(ii) Forfeiture of match on distributed excess contributions. A matching contribution is taken into account under section 401(a)(4) even if the match is with respect to an elective contribution that is distributed or recharacterized under this paragraph (b). This requires that, after correction of excess contributions, each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)-4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if elective contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(k)(3), while matching contributions attributable to those elective contributions remain allocated to the HCEs' accounts. Under section 411(a)(3)(G) and §1.411(a)-4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions or excess deferrals to avoid a violation of section 401(a)(4). See also §1.401(a)(4)-11(g)(vii)(B) regarding the use of additional allocations to the accounts of NHCEs for the purpose of correcting a discriminatory rate of matching contributions.

(iii) Permitted forfeiture of QMAC. Pursuant to section 401(k)(8)(E), a qualified matching contribution is not treated as forfeitable under §1.401(k)-1(c) merely because under the plan it is forfeited in accordance with paragraph (b)(4)(ii) of this section.

(iv) No requirement for recalculation. If excess contributions are distributed or recharacterized in accordance with paragraphs (b)(2) and (3) of this section, the cash or deferred arrangement is treated as meeting the nondiscrimination test of section

401(k)(3) regardless of whether the ADP for the HCEs, if recalculated after the distributions or recharacterizations, would satisfy section 401(k)(3).

(v) Treatment of excess contributions that are catch-up contributions. A cash or deferred arrangement does not fail to meet the requirements of section 401(k)(3) and paragraph (a)(1) of this section merely because excess contributions that are catch-up contributions because they exceed the ADP limit, as described in §1.414(v)-1(b)(1)(iii), are not corrected in accordance with this paragraph (b).

(5) Failure to timely correct--(i) Failure to correct within 2½ months after end of plan year. If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10% excise tax on the amount of the excess contributions. See section 4979 and §54.4979-1 of this chapter. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (a)(6) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) Failure to correct within 12 months after end of plan year. If excess contributions are not corrected within 12 months after the close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

(c) Additional rules for prior year testing method--(1) Rules for change in testing method--(i) General rule. A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in paragraph (c)(1)(ii) of this section. For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(k)-3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year.

(ii) Situations permitting a change to the prior year testing method. The situations described in this paragraph (c)(1)(ii) are:

(A) The plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan).

(B) The plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan).

(C) A transaction described in section 410(b)(6)(C)(i) and §1.410(b)-2(f) occurs and--

(1) As a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and

(2) The change from the current year testing method to the prior year testing method occurs within the transition period described in section 410(b)(6)(C)(ii).

(2) Calculation of ADP under the prior year testing method for the first plan year--(i) Plans that are not successor plans. If, for the first plan year of any plan (other than a successor plan), the plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ADP for eligible NHCEs, or use 3% as the ADP for eligible NHCEs, for applying the ADP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting on QNECs under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) First plan year defined. For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for elective contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)-7(b)) for a plan year if for such plan year the plan is aggregated under §1.401(k)-1(b)(4) with any other plan that provides for elective contributions in the prior year.

(iii) Successor plans. A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under a qualified cash or deferred arrangement maintained by the employer in the prior year. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ADP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) Plans using different testing methods for the ADP and ACP test. Except as

otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ADP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ACP test for that year. For example, a plan may use the prior year testing method for the ADP test and the current year testing method for its ACP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use--

(i) The recharacterization method of paragraph (b)(3) of this section to correct excess contributions for a plan year;

(ii) The rules of §1.401(m)-2(a)(6)(ii) to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph (a)(6)(v) of this section to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) <u>Rules for plan coverage changes</u>--(i) <u>In general</u>. A plan that uses the prior year testing method and experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ADP for the NHCEs for the plan year is the weighted average of the ADPs for the prior year subgroups.

(ii) <u>Optional rule for minor plan coverage changes</u>. If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ADP for the group of eligible NHCEs for the prior year under the plan is the ADP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) Definitions. The following definitions apply for purposes of this paragraph (c)(4):

(A) Plan coverage change. The term plan coverage change means a change in the group or groups of eligible employees under a plan on account of--

(1) The establishment or amendment of a plan;

(2) A plan merger or spinoff under section 414(l);

(3) A change in the way plans (within the meaning of §1.410(b)-7(b)) are combined or separated for purposes of §1.401(k)-1(b)(4) (e.g., permissively aggregating plans not previously aggregated under §1.410(b)-7(d), or ceasing to permissively aggregate plans under §1.410(b)-7(d));

(4) A reclassification of a substantial group of employees that has the same effect as amending the plan (e.g., a transfer of a substantial group of employees from one division to another division); or

(5) A combination of any of paragraphs (c)(4)(iii)(A)(1) through (4) of this section.

(B) Prior year subgroup. The term prior year subgroup means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan maintained by the employer that included a qualified cash or deferred arrangement and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) <u>Weighted average of the ADPs for the prior year subgroups</u>. The term weighted average of the ADPs for the prior year subgroups means the sum, for all prior year subgroups, of the adjusted ADPs for the plan year. The term adjusted ADP with respect to a prior year subgroup means the ADP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) <u>Examples</u>. The following examples illustrate the application of this paragraph (c)(4):

<u>Example 1</u>. (i) Employer B maintains two calendar year plans, Plan O and Plan P, each of which includes a cash or deferred arrangement. The plans were not permissively aggregated under §1.410(b)-7(d) for the 2005 plan year. Both plans use the prior year testing method. Plan O had 300 eligible employees who were NHCEs for the 2005 plan year, and their ADP for that year was 6%. Sixty of the eligible employees who were NHCEs for the 2005 plan year under Plan O, terminated their employment during that year. Plan P had 100 eligible employees who were NHCEs for 2005, and the ADP for those NHCEs for that plan was 4%. Plan O and Plan P are permissively aggregated under §1.410(b)-7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under § 1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of §1.401(k)-1(b)(4). Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) The Plan O prior year subgroup consists of the 300 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.5%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) x 300/400 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) x 100/400 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

(v) As provided in paragraph (c)(4)(iii)(B) of this section, the determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether that NHCE terminated employed during the prior year. Thus, the prior ADP for the NHCEs under Plan OP for the 2006 plan year is unaffected by the termination of the 60 NHCEs covered by Plan O during the 2005 plan year.

Example 2. (i) The facts are the same as Example 1, except that the 60 employees who terminated employment during the 2005 plan are instead spun-off to another plan.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under §1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of §1.401(k)-1(b)(4) and the spin-off of the 60 employees is a plan coverage change. Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) For purposes of determining the prior year subgroups, the employees who would have been eligible employees in the prior year under the plan being tested are determined as if both plan coverage changes had first been effective as of the first day of the prior plan year. The Plan O prior year subgroup consists of the 240 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and would have been eligible under Plan OP for the 2005 plan year if the spin-off had occurred at the beginning of the 2005 plan year and Plan O and Plan P had been permissively aggregated under §1.410(b)-7(d) for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated under §1.410(b)-7(d) for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan O and the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan P. The adjusted ADP for the prior year subgroup consisting of eligible NHCEs under Plan O is 4.23%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) x 240/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the prior year subgroup consisting of the eligible NHCEs from Plan P is 1.18%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) x 100/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.41% (the sum of adjusted ADPs for the prior year subgroups, 4.23% plus 1.18%).

Example 3. (i) The facts are the same as in Example 1, except that instead of Plan O and Plan P being permissively aggregated for the 2006 plan year, 200 of the employees eligible under Plan O were spun-off from Plan O and merged into Plan P.

(ii) The spin-off from Plan O and merger to Plan P for the 2006 plan year are plan coverage changes for Plan P. Therefore, the prior year ADP for the NHCEs under Plan P for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan P. There are 2 subgroups under Plan P for the 2006 plan year. The Plan O prior year subgroup consists of the 200 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan P for the 2005 plan year if the spin-off and merger had occurred on the first day of the 2005 plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P for the 2005 plan year.

(iii) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.0%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) x 200/300 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1.33%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) x 100/300 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan P for the 2006 plan year is 5.33% (the sum of adjusted ADPs for the 2 prior year subgroups, 4.0% plus 1.33%).

(iv) The spin-off from Plan O for the 2006 plan year is a plan coverage change for Plan O. Therefore, the prior year ADP for the NHCEs under Plan O for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan O. In this case, there is only one prior year subgroup under Plan O, the employees who were NHCEs of Employer B for the 2005 plan year and who were eligible for the 2005 plan year under Plan O. Because there is only one prior year subgroup under Plan O, the weighted average of the ADPs for the prior year subgroup under Plan O is equal to the NHCE ADP for the prior year (2005 plan year) under Plan O, or 6%.

<u>Example 4</u>. (i) Employer C maintains a calendar year plan, Plan Q, which includes a cash or deferred arrangement that uses the prior year testing method. Plan Q covers employees of Division A and Division B. In 2005, Plan Q had 500 eligible employees who were NHCEs, and the ADP for those NHCEs for 2005 was 2%. Effective January 1, 2006, Employer C amends the eligibility provisions under Plan Q to exclude employees of Division B effective January 1, 2006. In addition, effective on that same date, Employer C establishes a new calendar year plan, Plan R, which includes a cash or deferred arrangement that uses the prior year testing method. The only eligible employees under Plan R are the 100 employees of Division B who were eligible employees under Plan Q.

(ii) Plan R is a successor plan, within the meaning of paragraph (c)(2)(iii) of this section (because all of the employees were eligible employees under Plan Q in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The amendment to the eligibility provisions of Plan Q and the establishment of Plan R are plan coverage changes within the meaning of paragraph (c)(4)(iii)(A) of this section for Plan Q and Plan R. Accordingly, each plan must determine the NHCE ADP for the 2006 plan year under the rules set forth in paragraph (c)(4) of this section.

(iv) The prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 2005 plan year if the amendment to the Plan Q eligibility provisions had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 plan year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as if the plan amendment had not occurred.

(v) Similarly, Plan R has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan R for the 2005 plan year if the plan were established as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

<u>Example 5</u>. (i) The facts are the same as in <u>Example 4</u>, except that the provisions of Plan R extend eligibility to 50 hourly employees who previously were not eligible employees under any qualified cash or deferred arrangement maintained by Employer C.

(ii) Plan R is a successor plan (because 100 of Plan R's 150 eligible employees were eligible employees under another qualified cash or deferred arrangement maintained by Employer C in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The establishment of Plan R is a plan coverage change that affects Plan R. Because the 50 hourly employees were not eligible employees under any qualified cash or deferred arrangement of Employer C for the prior plan year, they do not comprise a prior year subgroup. Accordingly, Plan R still has only one prior year subgroup. Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

§1.401(k)-3 Safe harbor requirements.

(a) ADP test safe harbor. A cash or deferred arrangement satisfies the ADP safe harbor provision of section 401(k)(12) for a plan year if the arrangement satisfies the safe harbor contribution requirement of paragraph (b) or (c) of this section for the plan year, the notice requirement of paragraph (d) of this section, the plan year requirements of paragraph (e) of this section, and the additional rules of paragraphs (f), (g) and (h) of this section, as applicable. Pursuant to section 401(k)(12)(E)(ii), the safe harbor contribution requirement of paragraph (b) or (c) of this section must be satisfied without regard to section 401(l). The contributions made under paragraphs (b) and (c) of this section are referred to as safe harbor nonelective contributions and safe harbor matching contributions, respectively.

(b) Safe harbor nonelective contribution requirement--(1) General rule. The safe harbor nonelective contribution requirement of this paragraph is satisfied if, under the terms of the plan, the employer is required to make a qualified nonelective contribution on behalf of each eligible NHCE equal to at least 3% of the employee's safe harbor compensation.

(2) Safe harbor compensation defined. For purposes of this section, safe harbor compensation means compensation as defined in §1.401(k)-6 (which incorporates the

definition of compensation in §1.414(s)-1); provided, however, that the rule in the last sentence of §1.414(s)-1(d)(2)(iii) (which generally permits a definition of compensation to exclude all compensation in excess of a specified dollar amount) does not apply in determining the safe harbor compensation of NHCEs. Thus, for example, the plan may limit the period used to determine safe harbor compensation to the eligible employee's period of participation.

(c) Safe harbor matching contribution requirement--(1) In general. The safe harbor matching contribution requirement of this paragraph (c) is satisfied if, under the plan, qualified matching contributions are made on behalf of each eligible NHCE in an amount determined under the basic matching formula of section 401(k)(12)(B)(i)(I), as described in paragraph (c)(2) of this section, or under an enhanced matching formula of section 401(k)(12)(B)(i)(II), as described in paragraph (c)(3) of this section.

(2) Basic matching formula. Under the basic matching formula, each eligible NHCE receives qualified matching contributions in an amount equal to the sum of--

(i) 100% of the amount of the employee's elective contributions that do not exceed 3% of the employee's safe harbor compensation; and

(ii) 50% of the amount of the employee's elective contributions that exceed 3% of the employee's safe harbor compensation but that do not exceed 5% of the employee's safe harbor compensation.

(3) Enhanced matching formula. Under an enhanced matching formula, each eligible NHCE receives a matching contribution under a formula that, at any rate of elective contributions by the employee, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching

contributions that would have been provided under the basic matching formula of paragraph (c)(2) of this section. In addition, under an enhanced matching formula, the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective contributions may not increase as the amount of an employee's elective contributions increases.

(4) Limitation on HCE matching contributions. The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if the ratio of matching contributions made on account of an HCE's elective contributions under the cash or deferred arrangement for a plan year to those elective contributions is greater than the ratio of matching contributions to elective contributions that would apply with respect to any eligible NHCE with elective contributions at the same percentage of safe harbor compensation.

(5) Use of safe harbor match not precluded by certain plan provisions--(i) Safe harbor matching contributions on employee contributions. The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions are made with respect to the sum of elective contributions and employee contributions on the same terms as safe harbor matching contributions are made with respect to elective contributions. Alternatively, the safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions on elective contributions are not affected by the amount of employee

contributions.

(ii) Periodic matching contributions. The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because the plan provides that safe harbor matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that safe harbor matching contributions with respect to any elective contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(6) Permissible restrictions on elective contributions by NHCEs--(i) General rule. The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if elective contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (c)(6).

(ii) Restrictions on election periods. A plan may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (d) of this section) to make or change a cash or deferred election for the plan year. For purposes of this paragraph (c)(6)(ii), a 30-day period is deemed to be a reasonable period to make or change a cash or deferred election.

(iii) Restrictions on amount of elective contributions. A plan is permitted to limit the amount of elective contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (c)(6)(v) of this section) to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of elective contributions. However, a plan may require eligible employees to make cash or deferred elections in whole percentages of compensation or whole dollar amounts.

(iv) Restrictions on types of compensation that may be deferred. A plan may limit the types of compensation that may be deferred by an eligible employee under a plan, provided that each eligible NHCE is permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)-1(d)(2). Thus, the definition of compensation from which elective contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)-1(d)(3).

(v) Restrictions due to limitations under the Internal Revenue Code. A plan may limit the amount of elective contributions made by an eligible employee under a plan--

(A) Because of the limitations of section 402(g) or section 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make elective contributions has been suspended for 6 months in accordance with §1.401(k)-1(d)(3)(iv)(E).

(7) Examples. The following examples illustrate the safe harbor contribution requirement of this paragraph (c):

Example 1. (i) Beginning January 1, 2006, Employer A maintains Plan L covering employees (including HCEs and NHCEs) in Divisions D and E. Plan L contains a cash or deferred arrangement and provides qualified matching contributions equal to

100% of each eligible employee's elective contributions up to 3% of compensation and 50% of the next 2% of compensation. For purposes of the matching contribution formula, safe harbor compensation is defined as all compensation within the meaning of section 415(c)(3) (a definition that satisfies section 414(s)). Also, each employee is permitted to make elective contributions from all safe harbor compensation within the meaning of section 415(c)(3) and may change a cash or deferred election at any time. Plan L limits the amount of an employee's elective contributions for purposes of section 402(g) and section 415, and, in the case of a hardship distribution, suspends an employee's ability to make elective contributions for 6 months in accordance with §1.401(k)-1(d)(3)(iv)(E). All contributions under Plan L are nonforfeitable and are subject to the withdrawal restrictions of section 401(k)(2)(B). Plan L provides for no other contributions and Employer A maintains no other plans. Plan L is maintained on a calendar-year basis and all contributions for a plan year are made within 12 months after the end of the plan year.

(ii) Based on these facts, matching contributions under Plan L are safe harbor matching contributions because they are qualified matching contributions equal to the basic matching formula. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

Example 2. (i) The facts are the same as in Example 1, except that instead of providing a basic matching contribution, Plan L provides a qualified matching contribution equal to 100% of each eligible employee's elective contributions up to 4% of safe harbor compensation.

(ii) Plan L's formula is an enhanced matching formula because each eligible NHCE receives safe harbor matching contributions at a rate that, at any rate of elective contributions, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been received under the basic safe harbor matching formula, and the rate of matching contributions does not increase as the rate of an employee's elective contributions increases. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

Example 3. (i) The facts are the same as in Example 1, except that instead of permitting each employee to make elective contributions from all compensation within the meaning of section 415(c)(3), each employee's elective contributions under Plan L are limited to 15% of the employee's "basic compensation." Basic compensation is defined under Plan L as compensation within the meaning of section 415(c)(3), but excluding overtime pay.

(ii) The definition of basic compensation under Plan L is a reasonable definition of compensation within the meaning of §1.414(s)-1(d)(2).

(iii) Plan L will not fail to satisfy the safe harbor contribution requirement of this paragraph (c) merely because Plan L limits the amount of elective contributions and the types of compensation that may be deferred by eligible employees, provided that each eligible NHCE may make elective contributions equal to at least 4% of the employee's safe harbor compensation.

Example 4. (i) The facts are the same as in Example 1, except that Plan L provides that only employees employed on the last day of the plan year will receive a safe harbor matching contribution.

(ii) Even if the plan that provides for employee contributions and matching contributions satisfies the minimum coverage requirements of section 410(b)(1) taking into account this last-day requirement, Plan L would not satisfy the safe harbor contribution requirement of this paragraph (c) because safe harbor matching contributions are not made on behalf of all eligible NHCEs who make elective contributions.

(iii) The result would be the same if, instead of providing safe harbor matching contributions under an enhanced formula, Plan L provides for a 3% safe harbor nonelective contribution that is restricted to eligible employees under the cash or deferred arrangement who are employed on the last day of the plan year.

Example 5. (i) The facts are the same as in Example 1, except that instead of providing qualified matching contributions under the basic matching formula to employees in both Divisions D and E, employees in Division E are provided qualified matching contributions under the basic matching formula, while safe harbor matching contributions continue to be provided to employees in Division D under the enhanced matching formula described in Example 2.

(ii) Even if Plan L satisfies §1.401(a)(4)-4 with respect to each rate of matching contributions available to employees under the plan, the plan would fail to satisfy the safe harbor contribution requirement of this paragraph (c) because the rate of matching contributions with respect to HCEs in Division D at a rate of elective contributions between 3% and 5% would be greater than that with respect to NHCEs in Division E at the same rate of elective contributions. For example, an HCE in Division D who would have a 4% rate of elective contributions would have a rate of matching contributions of 100% while an NHCE in Division E who would have the same rate of elective contributions would have a lower rate of matching contributions.

(d) Notice requirement--(1) General rule. The notice requirement of this paragraph (d) is satisfied for a plan year if each eligible employee is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement of paragraph (d)(2) of this section and the timing requirement of paragraph (d)(3) of this section.

(2) Content requirement--(i) General rule. The content requirement of this paragraph (d)(2) is satisfied if the notice is--

(A) Sufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan; and

(B) Written in a manner calculated to be understood by the average employee eligible to participate in the plan.

(ii) Minimum content requirement. Subject to the requirements of paragraph (d)(2)(iii) of this section, a notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes--

(A) The safe harbor matching contribution or safe harbor nonelective contribution formula used under the plan (including a description of the levels of safe harbor matching contributions, if any, available under the plan);

(B) Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;

(C) The plan to which safe harbor contributions will be made (if different than the plan containing the cash or deferred arrangement);

(D) The type and amount of compensation that may be deferred under the plan;

(E) How to make cash or deferred elections, including any administrative requirements that apply to such elections;

(F) The periods available under the plan for making cash or deferred elections;

(G) Withdrawal and vesting provisions applicable to contributions under the plan; and

(H) Information that makes it easy to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of individuals or offices from whom employees can obtain such plan information.

(iii) References to SPD. A plan will not fail to satisfy the content requirements of this paragraph (d)(2) merely because, in the case of information described in paragraph (d)(2)(ii)(B) of this section (relating to any other contributions under the plan), paragraph (d)(2)(ii)(C) of this section (relating to the plan to which safe harbor contributions will be made) or paragraph (d)(2)(ii)(D) of this section (relating to the type and amount of compensation that may be deferred under the plan), the notice cross-references the relevant portions of a summary plan description that provides the same information that would be provided in accordance with such paragraphs and that has been provided (or is concurrently provided) to employees.

(3) Timing requirement--(i) General rule. The timing requirement of this paragraph (d)(3) is satisfied if the notice is provided within a reasonable period before the beginning of the plan year (or, in the year an employee becomes eligible, within a reasonable period before the employee becomes eligible). The determination of whether a notice satisfies the timing requirement of this paragraph (d)(3) is based on all of the relevant facts and circumstances.

(ii) Deemed satisfaction of timing requirement. The timing requirement of this paragraph (d)(3) is deemed to be satisfied if at least 30 days (and no more than 90 days) before the beginning of each plan year, the notice is given to each eligible employee for the plan year. In the case of an employee who does not receive the notice within the period described in the previous sentence because the employee becomes eligible after the 90th day before the beginning of the plan year, the timing requirement is deemed to be satisfied if the notice is provided no more than 90 days before the employee becomes eligible (and no later than the date the employee becomes eligible). Thus, for example, the preceding sentence would apply in the case of any employee eligible for the first plan year under a newly established plan that provides for elective contributions, or would apply in the case of the first plan year in which an employee becomes eligible under an existing plan that provides for elective contributions.

(e) Plan year requirement--(1) General rule. Except as provided in this paragraph (e) or in paragraph (f) of this section, a plan will fail to satisfy the requirements of section 401(k)(12) and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of the plan year and remain in effect for an entire 12-month plan year. Moreover, if, as described under paragraph (g)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions specifying that the safe harbor contributions will be made in the other plan and providing that the contributions will be QNECs or QMACs must also be adopted before the first day of that plan year.

(2) Initial plan year. A newly established plan (other than a successor plan within the meaning of §1.401(k)-2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (e) merely because the plan year is less than 12 months, provided that

the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a cash or deferred arrangement will not fail to satisfy the requirement of this paragraph (e) if it is added to an existing profit sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during that year provided that--

(i) The plan is not a successor plan; and

(ii) The cash or deferred arrangement is made effective no later than 3 months prior to the end of the plan year.

(3) Change of plan year. A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the plan year has less than 12 months, provided that--

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section for the immediately following plan year.

(4) Final plan year. A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the final plan year is less than 12 months, provided that--

(i) The plan would satisfy the requirements of paragraph (g) of this section, treating the termination of the plan as a reduction or suspension of safe harbor matching contributions, other than the requirement that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections; or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(d).

(f) Plan amendments adopting safe harbor nonelective contributions--(1) General rule. Notwithstanding paragraph (e)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section using nonelective contributions under paragraph (b) of this section, but only if the plan provides the contingent and follow-up notices described in this section. A plan amendment made pursuant to this paragraph (f)(1) for a plan year may provide for the use of the safe harbor method described in this section solely for that plan year and a plan sponsor is not limited in the number of years for which it is permitted to adopt an amendment providing for the safe harbor method of this section using nonelective contributions under paragraph (b) of this section.

(2) Contingent notice provided. A plan satisfies the requirement to provide the contingent notice under this paragraph (f)(2) if it provides a notice that would satisfy the requirements of paragraph (d) of this section, except that, in lieu of setting forth the safe harbor contributions used under the plan as set forth in paragraph (d)(2)(ii)(A) of this section, the notice specifies that the plan may be amended during the plan year to include the safe harbor nonelective contribution and that, if the plan is amended, a follow-up notice will be provided.

(3) Follow-up notice requirement. A plan satisfies the requirement to provide a

follow-up notice under this paragraph (f)(3) if, no later than 30 days before the last day of the plan year, each eligible employee is given a notice that states that the safe harbor nonelective contributions will be made for the plan year. This notice is permitted to be combined with a contingent notice provided under paragraph (f)(2) of this section for the next plan year.

(g) Permissible reduction or suspension of safe harbor matching contributions– (1) General rule. A plan that provides for safe harbor matching contributions will not fail to satisfy the requirements of section 401(k)(3) for a plan year merely because the plan is amended during a plan year to reduce or suspend safe harbor matching contributions on future elective contributions (and, if applicable, employee contributions) provided that--

(i) All eligible employees are provided the supplemental notice in accordance with paragraph (g)(2) of this section;

(ii) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of 30 days after eligible employees are provided the notice described in paragraph (g)(2) of this section and the date the amendment is adopted;

(iii) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(iv) The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(k)-2(a)(2)(ii); and

(v) The plan satisfies the requirements of this section (other than this paragraph (g)) with respect to amounts deferred through the effective date of the amendment.

(2) Notice of suspension requirement. The notice of suspension requirement of this paragraph (g)(2) is satisfied if each eligible employee is given a written notice that explains--

(i) The consequences of the amendment which reduces or suspends matching contributions on future elective contributions and, if applicable, employee contributions;

(ii) The procedures for changing their cash or deferred election and, if applicable, their employee contribution elections; and

(iii) The effective date of the amendment.

(h) Additional rules--(1) Contributions taken into account. A contribution is taken into account for purposes of this section for a plan year if and only if the contribution would be taken into account for such plan year under the rules of §1.401(k)-2(a) or 1.401(m)-2(a). Thus, for example, a safe harbor matching contribution must be made within 12 months of the end of the plan year. Similarly, an elective contribution that would be taken into account for a plan year under §1.401(k)-2(a)(4)(i)(B)(2) must be taken into account for such plan year for purposes of this section, even if the compensation would have been received after the close of the plan year.

(2) Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests. A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies section 401(a)(4). Thus, these contributions are not subject to the limitations on qualified

nonelective contributions under §1.401(k)-2(a)(6)(ii), but are subject to the rules generally applicable to nonelective contributions under section 401(a)(4). See §1.401(a)(4)-1(b)(2)(ii). However, pursuant to section 401(k)(12)(E)(ii), to the extent they are needed to satisfy the safe harbor contribution requirement of paragraph (b) of this section, safe harbor nonelective contributions may not be taken into account under any plan for purposes of section 401(l) (including the imputation of permitted disparity under §1.401(a)(4)-7).

(3) Early participation rules. Section 401(k)(3)(F) and §1.401(k)-2(a)(1)(iii)(A), which provide an alternative nondiscrimination rule for certain plans that provide for early participation, do not apply for purposes of section 401(k)(12) and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees.

(4) Satisfying safe harbor contribution requirement under another defined contribution plan. Safe harbor matching or nonelective contributions may be made to the plan that contains the cash or deferred arrangement or to another defined contribution plan that satisfies section 401(a) or 403(a). If safe harbor contributions are made to another defined contribution plan, the safe harbor plan must specify the plan to which the safe harbors are made and contribution requirement of paragraph (b) or (c) of this section must be satisfied in the other defined contribution plan in the same manner as if the contributions were made to the plan that contains the cash or deferred arrangement. Consequently, the plan to which the contributions are made must have

the same plan year as the plan containing the cash and deferred arrangement and each employee eligible under the plan containing the cash or deferred arrangement must be eligible under the same conditions under the other defined contribution plan. The plan to which the safe harbor contributions are made need not be a plan that can be aggregated with the plan that contains the cash or deferred arrangement.

(5) Contributions used only once. Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

§1.401(k)-4 SIMPLE 401(k) plan requirements.

(a) General rule. A cash or deferred arrangement satisfies the SIMPLE 401(k) plan provision of section 401(k)(11) for a plan year if the arrangement satisfies the requirements of paragraphs (b) through (i) of this section for that year. A plan that contains a cash or deferred arrangement that satisfies this section is referred to as a SIMPLE 401(k) plan. Pursuant to section 401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the ADP test of section 401(k)(3)(A)(ii) for that year.

(b) Eligible employer--(1) General rule. A SIMPLE 401(k) plan must be established by an eligible employer. Eligible employer for purposes of this section means, with respect to any plan year, an employer that had no more than 100 employees who received at least $5,000 of SIMPLE compensation, as defined in paragraph (e)(5) of this section, from the employer for the prior calendar year.

(2) Special rule. An eligible employer that establishes a SIMPLE 401(k) plan for a plan year and that fails to be an eligible employer for any subsequent plan year, is treated as an eligible employer for the 2 plan years following the last plan year the

employer was an eligible employer. If the failure is due to any acquisition, disposition, or similar transaction involving an eligible employer, the preceding sentence applies only if the provisions of section 410(b)(6)(C)(i) are satisfied.

(c) Exclusive plan--(1) General rule. The SIMPLE 401(k) plan must be the exclusive plan for each SIMPLE 401(k) plan participant for the plan year. This requirement is satisfied if there are no contributions made, or benefits accrued, for services during the plan year on behalf of any SIMPLE 401(k) plan participant under any other qualified plan maintained by the employer. Other qualified plan for purposes of this section means any plan, contract, pension, or trust described in section 219(g)(5)(A) or (B).

(2) Special rule. A SIMPLE 401(k) plan will not be treated as failing the requirements of this paragraph (c) merely because any SIMPLE 401(k) plan participant receives an allocation of forfeitures under another plan of the employer.

(d) Election and notice--(1) General rule. An eligible employer establishing or maintaining a SIMPLE 401(k) plan must satisfy the election and notice requirements in paragraphs (d)(2) and (d)(3) of this section.

(2) Employee elections--(i) Initial plan year of participation. For the plan year in which an employee first becomes eligible under the SIMPLE 401(k) plan, the employee must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before.

(ii) Subsequent plan years. For each subsequent plan year, each eligible employee must be permitted to make or modify his cash or deferred election during the 60-day period immediately preceding such plan year.

(iii) Election to terminate. An eligible employee must be permitted to terminate his cash or deferred election at any time. If an employee does terminate his cash or deferred election, the plan is permitted to provide that such employee cannot have elective contributions made under the plan for the remainder of the plan year.

(3) Employee notices. The employer must notify each eligible employee within a reasonable time prior to each 60-day election period, or on the day the election period starts, that he or she can make a cash or deferred election, or modify a prior election, if applicable, during that period. The notice must state whether the eligible employer will make the matching contributions described in paragraph (e)(3) of this section or the nonelective contributions described in paragraph (e)(4) of this section.

(e) Contributions--(1) General rule. A SIMPLE 401(k) plan satisfies the contribution requirements of this paragraph (e) for a plan year only if no contributions may be made to the SIMPLE 401(k) plan during such year, other than contributions described in this paragraph (e) and rollover contributions described in §1.402(c)-2, Q&A-1(a).

(2) Elective contributions. Subject to the limitations on annual additions under section 415, each eligible employee must be permitted to make an election to have up to $10,000 of elective contributions made on the employee's behalf under the SIMPLE 401(k) plan for a plan year. The $10,000 limit is increased beginning in 2006 in the same manner as the $160,000 amount is adjusted under section 415(d), except that pursuant to section 408(p)(2)(E)(ii) the base period shall be the calendar quarter beginning July 1, 2004 and any increase which is not a multiple of $500 is rounded to the next lower multiple of $500.

(3) Matching contributions. Each plan year, the eligible employer must contribute a matching contribution to the account of each eligible employee on whose behalf elective contributions were made for the plan year. The amount of the matching contribution must equal the lesser of the eligible employee's elective contributions for the plan year or 3% of the eligible employee's SIMPLE compensation for the entire plan year.

(4) Nonelective contributions. For any plan year, in lieu of contributing matching contributions described in paragraph (e)(3) of this section, an eligible employer may, in accordance with plan terms, contribute a nonelective contribution to the account of each eligible employee in an amount equal to 2% of the eligible employee's SIMPLE compensation for the entire plan year. The eligible employer may limit the nonelective contributions to those eligible employees who received at least $5,000 of SIMPLE compensation from the employer for the entire plan year.

(5) SIMPLE compensation. Except as otherwise provided, the term SIMPLE compensation for purposes of this section means the sum of wages, tips, and other compensation from the eligible employer subject to federal income tax withholding (as described in section 6051(a)(3)) and the employee's elective contributions made under any other plan, and if applicable, elective deferrals under a section 408(p) SIMPLE IRA plan, a section 408(k)(6) SARSEP, or a plan or contract that satisfies the requirements of section 403(b), and compensation deferred under a section 457 plan, required to be reported by the employer on Form W-2 (as described in section 6051(a)(8)). For self-employed individuals, SIMPLE compensation means net earnings from self-employment determined under section 1402(a) prior to subtracting any contributions made under the

SIMPLE 401(k) plan on behalf of the individual.

(f) Vesting. All benefits attributable to contributions described in paragraph (e) of this section must be nonforfeitable at all times.

(g) Plan year. The plan year of a SIMPLE 401(k) plan must be the whole calendar year. Thus, in general, a SIMPLE 401(k) plan can be established only on January 1 and can be terminated only on December 31. However, in the case of an employer that did not previously maintain a SIMPLE 401(k) plan, the establishment date can be as late as October 1 (or later in the case of an employer that comes into existence after October 1 and establishes the SIMPLE 401(k) plan as soon as administratively feasible after the employer comes into existence).

(h) Other rules. A SIMPLE 401(k) plan is not treated as a top-heavy plan under section 416. See section 416(g)(4)(G).

§1.401(k)-5 Special rules for mergers, acquisitions and similar events. [*Reserved*].

§1.401(k)-6 Definitions.

Unless otherwise provided, the definitions of this section govern for purposes of section 401(k) and the regulations thereunder.

Actual contribution percentage (ACP) test. Actual contribution percentage test or ACP test means the test described in §1.401(m)-2(a)(1).

Actual deferral percentage (ADP). Actual deferral percentage or ADP means the ADP of the group of eligible employees as defined in §1.401(k)-2(a)(2).

Actual deferral percentage (ADP) test. Actual deferral percentage test or ADP test means the test described in §1.401(k)-2(a)(1).

Actual deferral ratio (ADR). Actual deferral ratio or ADR means the ADR of an eligible employee as defined in §1.401(k)-2(a)(3).

Cash or deferred arrangement. Cash or deferred arrangement is defined in §1.401(k)-1(a)(2).

Cash or deferred election. Cash or deferred election is defined in §1.401(k)-1(a)(3).

Compensation. Compensation means compensation as defined in section 414(s) and §1.414(s)-1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year. A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year. In the case of an HCE whose ADR is determined under §1.401(k)-2(a)(3)(ii), period of participation includes periods under another plan for which elective contributions are aggregated under §1.401(k)-2(a)(3)(ii). See also section 401(a)(17) and §1.401(a)(17)-1(c)(1).

Current year testing method. Current year testing method means the testing method described in §1.401(k)-2(a)(2)(ii) or §1.401(m)-2(a)(2)(ii) under which the applicable year is the current plan year.

Elective contributions. Elective contributions means employer contributions made to a plan pursuant to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under §1.401(k)-1(a)(4)).

Eligible employee--(1) General rule. Eligible employee means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts.

(2) Conditions on eligibility. An employee who is unable to make a cash or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make a cash or deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See §1.401(k)-1(e)(5), however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1).

(3) Certain one-time elections. An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the

employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in §1.401(k)-1(a)(3)(v) relating to the definition of a cash or deferred election. In no event is an election made after December 23, 1994, treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

Eligible HCE. Eligible HCE means an eligible employee who is an HCE.

Eligible NHCE. Eligible NHCE means an eligible employee who is not an HCE.

Employee. Employee means an employee within the meaning of §1.410(b)-9.

Employee stock ownership plan (ESOP). Employee stock ownership plan or ESOP means the portion of a plan that is an ESOP within the meaning of §1.410(b)-7(c)(2).

Employer. Employer means an employer within the meaning of §1.410(b)-9.

Excess contributions. Excess contributions means, with respect to a plan year, the amount of total excess contributions apportioned to an HCE under §1.401(k)-2(b)(2)(iii).

Excess deferrals. Excess deferrals means excess deferrals as defined in §1.402(g)-1(e)(3).

Highly compensated employee (HCE). Highly compensated employee or HCE has the meaning provided in section 414(q).

Matching contributions. Matching contributions means matching contributions as defined in §1.401(m)-1(a)(2).

Nonelective contributions. Nonelective contributions means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

Non-employee stock ownership plan (non-ESOP). Non-employee stock ownership plan or non-ESOP means the portion of a plan that is not an ESOP within the meaning of §1.410(b)-7(c)(2).

Non-highly compensated employee (NHCE). Non-highly compensated employee or NHCE means an employee who is not an HCE.

Plan. Plan is defined in §1.401(k)-1(b)(4).

Pre-ERISA money purchase pension plan. (1) Pre-ERISA money purchase pension plan is a pension plan--

(i) That is a defined contribution plan (as defined in section 414(i));

(ii) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement; and

(iii) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(2) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the

plan.

Prior year testing method. Prior year testing method means the testing method under which the applicable year is the prior plan year, as described in §1.401(k)-2(a)(2)(ii) or §1.401(m)-2(a)(2)(ii).

Qualified matching contributions (QMACs). Qualified matching contributions or QMACs means matching contributions that, except as provided otherwise in §1.401(k)-1(c) and (d), satisfy the requirements of §1.401(k)-1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)-2(a)(6) or the ACP test under §1.401(m)-2(a)(6). Thus, the matching contributions must satisfy the vesting requirements of §1.401(k)-1(c) and be subject to the distribution requirements of §1.401(k)-1(d) when they are contributed to the plan. See also §1.401(k)-2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) because it is a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

Qualified nonelective contributions (QNECs). Qualified nonelective contributions or QNECs means employer contributions, other than elective contributions or matching contributions, that, except as provided otherwise in §1.401(k)-1(c) and (d), satisfy the requirements of §1.401(k)-1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)-2(a)(6) or the ACP test under §1.401(m)-2(a)(6). Thus, the nonelective contributions must satisfy the vesting requirements of §1.401(k)-

1(c) and be subject to the distribution requirements of §1.401(k)-1(d) when they are contributed to the plan.

Rural cooperative plans. Rural cooperative plan means a plan described in section 401(k)(7).

Par. 3. Sections 1.401(m)-0 through 1.401(m)-2 are revised and sections 1.401(m)-3 through 1.401(m)-5 are added to read as follows:

§1.401(m)-0 Table of contents.

This section contains first a list of section headings and then a list of the paragraphs in each section in §§1.401(m)-1 through 1.401(m)-5.

LIST OF SECTIONS

LIST OF PARAGRAPHS

<u>§1.401(m)-2 ACP test</u>.

(iii) Qualified matching contributions used to satisfy the ADP test.
(iv) Matching contributions taken into account under safe harbor provisions.
(v) Treatment of forfeited matching contributions.
(6) Qualified nonelective contributions and elective contributions that may be taken into account under the ACP test.
(i) Timing of allocation.
(ii) Elective contributions taken into account under the ACP test.
(iii) Requirement that amount satisfy section 401(a)(4).
(iv) Aggregation must be permitted.
(v) Disproportionate contributions not taken into account.
(A) General rule.
(B) Definition of representative contribution rate.
(C) Definition of applicable contribution rate.
(vi) Contribution only used once.
(7) Examples.
(b) Correction of excess aggregate contributions.
(1) Permissible correction methods.
(i) In general.
(A) Additional contributions.
(B) Excess aggregate contributions distributed or forfeited.
(ii) Combination of correction methods.
(iii) Exclusive means of correction.
(2) Correction through distribution.
(i) General rule.
(ii) Calculation of total amount to be distributed.
(A) Calculate the dollar amount of excess aggregate contributions for each HCE.
(B) Determination of the total amount of excess aggregate contributions.
(C) Satisfaction of ACP.
(iii) Apportionment of total amount of excess aggregate contributions among the HCEs.
(A) Calculate the dollar amount of excess aggregate contributions for each HCE.
(B) Limit on amount apportioned to any HCE.
(C) Apportionment to additional HCEs.
(iv) Income allocable to excess aggregate contributions.
(A) General rule.
(B) Method of allocating income.
(C) Alternative method of allocating income for the plan year.
(D) Safe harbor method of allocating gap period income.
(E) Alternative method of allocating plan year and gap period income.
(F) Allocable income for recharacterized elective contributions.
(v) Distribution and forfeiture.
(vi) Tax treatment of corrective distributions.
(A) General rule.
(B) Rule for de minimis distributions.
(3) Other rules.
(i) No employee or spousal consent required.

§1.401(m)-3 Safe harbor requirements.

§1.401(m)-1 Employee contributions and matching contributions.

(a) General nondiscrimination rules--(1) Nondiscriminatory amount of contributions--(i) Exclusive means of amounts testing. A defined contribution plan does not satisfy section 401(a) for a plan year unless the amount of employee contributions and matching contributions to the plan for the plan year satisfies section 401(a)(4). The amount of employee contributions and matching contributions under a plan satisfies the requirements of section 401(a)(4) with respect to amounts if and only if the amount of employee contributions and matching contributions satisfies the nondiscrimination test of section 401(m) under paragraph (b) of this section and the plan satisfies the additional requirements of paragraph (c) of this section. See §1.401(a)(4)-1(b)(2)(ii)(B).

(ii) Testing benefits, rights and features. A plan that provides for employee contributions or matching contributions must satisfy the requirements of section 401(a)(4) relating to benefits, rights and features in addition to the requirement regarding amounts described in paragraph (a)(1)(i) of this section. For example, the right to make each level of employee contributions and the right to each level of matching contributions under the plan are benefits, rights or features subject to the requirements of section 401(a)(4). See §1.401(a)(4)-4(e)(3)(i) and (iii)(F) through (G).

(2) Matching contributions--(i) In general. For purposes of section 401(m), this section and §§1.401(m)-2 through 1.401(m)-5, matching contributions are--

(A) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an employee contribution to a plan maintained by the employer;

(B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral; and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective deferrals.

(ii) Employer contributions made on account of an employee contribution or elective deferral. Whether an employer contribution is made on account of an employee contribution or an elective deferral is determined on the basis of all the relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. An employer contribution made to a defined contribution plan on account of contributions made by an employee under an employer-sponsored savings arrangement that are not held in a plan that is intended to be a qualified plan or a plan described in §1.402(g)-1(b) is not a matching contribution.

(iii) Employer contributions not on account of an employee contribution or elective deferral. An employer contribution is not a matching contribution made on account of an elective deferral if it is contributed before the cash or deferred election is made or before the employee's performance of services with respect to which the elective deferral is made (or when the cash that is subject to the cash or deferred election would be currently available, if earlier). In addition, an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution.

(3) Employee contributions--(i) In general. For purposes of section 401(m), this section and §§1.401(m)-2 through 1.401(m)-5, employee contributions are contributions to a plan that are designated or treated at the time of contribution as after-tax employee contributions (e.g., by treating the contributions as taxable income subject to applicable withholding requirements) and are allocated to an individual account for each eligible employee to which attributable earnings and losses are allocated. See §1.401(k)-1(a)(2)(ii). The term employee contributions includes--

(A) Employee contributions to the defined contribution portion of a plan described in section 414(k);

(B) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(C) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions under §1.401(k)-2(b)(3); and

(D) Employee contributions to a plan or contract that satisfies the requirements of section 403(b).

(ii) Certain contributions not treated as employee contributions. The term employee contributions does not include repayment of loans, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to the plan from another plan.

(iii) Qualified cost-of-living arrangements. Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B) are treated as employee contributions to a defined contribution plan, without regard to the requirement that the employee contributions be allocated to an individual account to which attributable earnings and losses are allocated.

(b) Nondiscrimination requirements for amount of contributions--(1) Matching contributions and employee contributions. The matching contributions and employee contributions under a plan satisfy this paragraph (b) for a plan year only if the plan satisfies--

(i)The ACP test of section 401(m)(2) described in §1.401(m)-2;

(ii) The ACP safe harbor provisions of section 401(m)(11) described in §1.401(m)-3; or

(iii) The SIMPLE 401(k) provisions of sections 401(k)(11) and 401(m)(10) described in §1.401(k)-4.

(2) Automatic satisfaction by certain plans. Notwithstanding paragraph (b)(1) of this section, the requirements of this section are treated as satisfied with respect to employee contributions and matching contributions under a collectively bargained plan

(or the portion of a plan) that automatically satisfies section 410(b). See §§1.401(a)(4)-1(c)(5) and 1.410(b)-2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof). See sections 401(a)(5)(G), 403(b)(12)(C) and 410(c)(1)(A).

(3) Anti-abuse provisions. Sections 1.401(m)-1 through 1.401(m)-5 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ACP for NHCEs (which is used as a benchmark for testing the ACP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) Aggregation and restructuring--(i) In general. This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans that provide for employee contributions and matching contributions for purposes of this section and §§1.401(m)-2 through 1.401(m)-5.

(ii) Aggregation of employee contributions and matching contributions within a plan. Except as otherwise specifically provided in this paragraph (b)(4) and §1.401(m)-3(f)(1), a plan must be subject to a single test under paragraph (b)(1) of this section with respect to all employee contributions and matching contributions and all eligible employees under the plan. Thus, for example, if two groups of employees are eligible for matching contributions under a plan, all employee contributions and matching contributions under the plan must be subject to a single test, even if they have significantly different features, such as different rates of match.

(iii) Aggregation of plans--(A) In general. The term plan means a plan within the meaning of §1.410(b)-7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)-7(c), and the permissive aggregation rules of §1.410(b)-7(d), as modified by paragraph (b)(4)(v) of this section. Thus, for example, two plans (within the meaning of §1.410(b)-7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)-7(d) are treated as a single plan for purposes of sections 401(k) and 401(m).

(B) Arrangements with inconsistent ACP testing methods. Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all employee contributions and matching contributions and all eligible employees under a plan. Thus, in applying the permissive aggregation rules of §1.410(b)-7(d), an employer may not aggregate plans (within the meaning of §1.410(b)-7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)-7) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)-7) that is using the ACP safe harbor provisions of section 401(m)(11) and another plan that is using the ACP test of section 401(m)(2).

(iv) Disaggregation of plans and separate testing--(A) In general. If employee contributions or matching contributions are included in a plan (within the meaning of §1.410(b)-7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the matching contributions and employee contributions under that plan must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a plan which provides for employee contributions or matching contributions are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(m), unless the employer is applying the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the plan. Similarly, if a plan that provides for employee contributions or matching contributions under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the plan must be treated as two separate plans, one comprising all eligible employees who have met the minimum age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the minimum age and service requirements of section 410(a)(1), unless the plan is using the rule in §1.401(m)-2(a)(1)(iii)(A).

(B) Restructuring prohibited. Restructuring under §1.401(a)(4)-9(c) may not be used to demonstrate compliance with the requirements of section 401(m). See §1.401(a)(4)-9(c)(3)(ii).

(v) Certain disaggregation rules not applicable. The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)-7(c)(1) and to ESOP and non-ESOP portions of a plan set forth in §1.410(b)-7(c)(2) shall not apply for purposes of this section and §§1.401(m)-2 through 1.401(m)-5. Accordingly, notwithstanding §1.410(b)-7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of §1.410(b)-7(b)) are permitted to be aggregated for these purposes.

(c) Additional requirements--(1) Separate testing for employee contributions and matching contributions. Under §1.410(b)-7(c)(1), the group of employees who are eligible to make employee contributions or eligible to receive matching contributions must satisfy the requirements of section 410(b) as if those employees were covered under a separate plan. The determination of whether the separate plan satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. In addition, except as expressly permitted under section 401(k), 410(b)(2)(A)(ii), or 416(c)(2)(A), employee contributions, matching contributions and elective contributions taken into account under §1.401(m)-2(a)(6) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee contributions or matching contributions are made) satisfy the requirements of section 401(a). See also §1.401(a)(4)-11(g)(3)(vii) for special rules relating to corrections of violations of the minimum coverage requirements or discriminatory rates of matching contributions.

(2) Plan provision requirement. A plan that provides for employee contributions or matching contributions satisfies this section only if it provides that the nondiscrimination requirements of section 401(m) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ACP test of section 401(m)(2), as described in paragraph (b)(1)(i) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ACP for eligible NHCEs for the first plan year is 3% or the ACP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(m)(11), as described in paragraph (b)(1)(ii) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ACP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (c)(2), a plan may incorporate by reference the provisions of section 401(m)(2) and §1.401(m)-2 if that is the nondiscrimination test being applied.

(d) Effective date. This section and §§1.401(m)-2 through 1.401(m)-5 apply to plan years that begin on or after the date that is 12 months after the issuance of these regulations in final form.

§1.401(m)-2 ACP test.

(a) Actual contribution percentage (ACP) test--(1) In general--(i) ACP test formula. A plan satisfies the ACP test for a plan year only if--

(A) The ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ACP for the eligible HCEs for the plan year over the ACP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) HCEs as sole eligible employees. If, for the applicable year there are no eligible NHCEs (i.e., all of the eligible employees under the plan for the applicable year are HCEs), the plan is deemed to satisfy the ACP test.

(iii) Special rule for early participation. If a plan providing for employee contributions or matching contributions provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the plan meets the requirements of section 410(b)(1), then in determining whether the plan meets the requirements under paragraph (a)(1) of this section either--

(A) Pursuant to section 401(m)(5)(C), the ACP test is performed under the plan (determined without regard to disaggregation under §1.410(b)-7(c)(3)), using the ACP for all eligible HCEs for the plan year and the ACP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(m)-1(b)(4), the plan is disaggregated into separate plans and the ACP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) Determination of ACP--(i) General rule. The ACP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ACRs of eligible employees in the group for that year. The ACP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) Determination of applicable year under current year and prior year testing method. The ACP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ACP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ACP test is being calculated. Under the prior year testing method, the ACP for the eligible NHCEs is determined using the ACRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ACP test is being performed. Under the current year testing method, the applicable year for determining the ACP for eligible NHCEs is the same plan year as the plan year for which the ACP test is being calculated. Under either method, the ACP for the eligible HCEs is the determined using the ACRs of eligible employees who are HCEs for the plan year for which the ACP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) Determination of ACR--(i) General rule. The ACR of an eligible employee for the plan year or applicable year is the sum of the employee contributions and matching contributions taken into account with respect to such employee (determined under the rules of paragraphs (a)(4) and (a)(5) of this section), and the qualified nonelective and elective contributions taken into account under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ACR is calculated to the nearest hundredth of a percentage point. If no employee contributions, matching contributions, elective contributions, or qualified nonelective contributions are taken into account under this section with respect to an eligible employee for the year, the ACR of the employee is zero.

(ii) ACR of HCEs eligible under more than one plan--(A) General rule. Pursuant to section 401(m)(2)(B), the ACR of an HCE who is an eligible employee in more than one plan of an employer to which matching contributions or employee contributions are made is calculated by treating all contributions with respect to such HCE under any such plan as being made under the plan being tested. Thus, the ACR for such an HCE is calculated by accumulating all matching contributions and employee contributions under any plan (other than a plan described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the plan under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ACR for the plan year of that plan for an HCE who participates in multiple plans of the same employer that provide for matching contributions or employee contributions is the sum of all such contributions during such 12-month period that would be taken into account with respect to the HCE under all plans in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(m)-3.

(B) Plans not permitted to be aggregated. Contributions under plans that are not permitted to be aggregated under §1.401(m)-1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(m)-1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)-7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) Example. The following example illustrates the application of paragraph (a)(3)(ii) of this section. See also §1.401(k)-2(a)(3)(iii) for additional examples of the application of the parallel rule under section 401(k)(3)(A). The example is as follows:

Example. Employee A, an HCE with compensation of $120,000, is eligible to make employee contributions under Plan S and Plan T, two calendar-year profit-sharing plans of Employer H. Plan S and Plan T use the same definition of compensation. Plan S provides a match equal to 50% of each employee's contributions and Plan T has no match. During the current plan year, Employee A elects to contribute $4,000 in employee contributions to Plan T and $4,000 in employee contributions to Plan S. There are no other contributions made on behalf of Employee A. Each plan must calculate Employee A's ACR by dividing the total employee contributions by Employee A and matching contributions under both plans by $120,000. Therefore, Employee A's ACR under each plan is 8.33% ($4,000+ $4,000+ $2,000/$120,000).

(4) Employee contributions and matching contributions taken into account under the ACP test--(i) Employee contributions. An employee contribution is taken into account in determining the ACR for an eligible employee for the plan year or applicable year in which the contribution is made. For purposes of the preceding sentence, an

amount withheld from an employee's pay (or a payment by the employee to an agent of the plan) is treated as contributed at the time of such withholding (or payment) if the funds paid are transmitted to the trust within a reasonable period after the withholding (or payment).

(ii) Recharacterized elective contributions. Excess contributions recharacterized in accordance with §1.401(k)-2(b)(3) are taken into account as employee contributions for the plan year that includes the time at which the excess contribution is includible in the gross income of the employee under §1.401(k)-2(b)(3)(ii)(A).

(iii) Matching contributions. A matching contribution is taken into account in determining the ACR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied--

(A) The matching contribution is allocated to the employee's account under the terms of the plan as of a date within that year;

(B) The matching contribution is made on account of (or the matching contribution is allocated on the basis of) the employee's elective deferrals or employee contributions for that year; and

(C) The matching contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year that contains that date.

(5) Matching contributions not taken into account under the ACP test--(i) General rule. Matching contributions that do not satisfy the requirements of paragraph (a)(4)(iii) of this section may not be taken into account in the ACP test for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the matching contributions must satisfy the requirements of section 401(a)(4)

(without regard to the ACP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. See §§1.401(a)(4)-1(b)(2)(ii)(B) and 1.410(b)-7(c)(1).

(ii) Disproportionate matching contributions--(A) Matching contributions in excess of 100%. A matching contribution with respect to any employee contribution or elective deferral for an NHCE is not taken into account under the ACP test to the extent the matching rate with respect to the employee contribution or elective deferral exceeds the greater of 100% and 2 times the plan's representative matching rate.

(B) Representative matching rate. For purposes of this paragraph (a)(5)(ii), the plan's representative matching rate is the lowest matching rate for any eligible NHCE among a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year who make elective deferrals or employee contributions for the plan year (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals or employee contributions for the plan year).

(C) Definition of matching rate. For purposes of this paragraph (a)(5)(ii), the matching rate for an employee is the matching contributions made for such employee divided by the elective deferrals or employee contributions that are being matched.

(iii) Qualified matching contributions used to satisfy the ADP test. Qualified matching contributions that are taken into account for the ADP test of section 401(k)(3) under §1.401(k)-2(a)(6) are not taken into account in determining an eligible employee's ACR.

(iv) Matching contributions taken into account under safe harbor provisions. A plan that satisfies the ACP safe harbor requirements of section 401(m)(11) for a plan year but nonetheless must satisfy the requirements of this section because it provides for employee contributions for such plan year is permitted to apply this section disregarding all matching contributions with respect to all eligible employees. In addition, a plan that satisfies the ADP safe harbor requirements of §1.401(k)-3 for a plan year using qualified matching contributions but does not satisfy the ACP safe harbor requirements of section 401(m)(11) for such plan year is permitted to apply this section by excluding matching contributions with respect to all eligible employees that do not exceed 4% of each employee's compensation. If a plan disregards matching contributions pursuant to this paragraph (a)(5)(iv), the disregard must apply with respect to all eligible employees.

(v) Treatment of forfeited matching contributions. A matching contribution that is forfeited because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution is not taken into account for purposes of this section.

(6) Qualified nonelective contributions and elective contributions that may be taken into account under the ACP test. Qualified nonelective contributions and elective contributions may be taken into account in determining the ACR for an eligible employee for a plan year or applicable year, but only to the extent the contributions satisfy the following requirements--

(i) Timing of allocation. The qualified nonelective contribution is allocated to the employee's account as of a date within that year (within the meaning of §1.401(k)-2(a)(4)(i)(A)) and the elective contribution satisfies §1.401(k)-2(a)(4)(i). Consequently, under the prior year testing method, in order to be taken into account in calculating the ACP for the group of eligible NHCEs for the applicable year, a qualified nonelective contribution must be contributed no later than the end of the 12-month period following the applicable year even though the applicable year is different than the plan year being tested.

(ii) Elective contributions taken into account under the ACP test. Elective contributions may be taken into account for the ACP test only if the cash or deferred arrangement under which the elective contributions are made is required to satisfy the ADP test in §1.401(k)-2(a)(1) and, then only to the extent that the cash or deferred arrangement would satisfy that test, including such elective contributions in the ADP for the plan year or applicable year. Thus, for example, elective deferrals made pursuant to a salary reduction agreement under an annuity described in section 403(b) are not permitted to be taken into account in an ACP test. Similarly, elective contributions under a cash or deferred arrangement that is using the section 401(k) safe harbor described in §1.401(k)-3 can not be taken into account in an ACP test.

(iii) Requirement that amount satisfy section 401(a)(4). The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)-2(a)(6), and the amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) for the ACP test and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)-2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)-1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the plan, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the plan, then the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iv) Aggregation must be permitted. The plan that provides for employee or matching contributions and the plan or plans to which the qualified nonelective contributions or elective contributions are made are plans that would be permitted to be aggregated under §1.401(m)-1(b)(4). If the plan year of the plan that provides for employee or matching contributions is changed to satisfy the requirement under §1.410(b)-7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and elective contributions may be taken into account in the resulting short plan year only if such qualified nonelective and elective contributions could have been taken into account under an ADP test for a plan with that same short plan year.

(v) Disproportionate contributions not taken into account--(A) General rule. Qualified nonelective contributions cannot be taken into account for an applicable year for an NHCE to the extent such contributions exceed the product that NHCE's compensation and the greater of 5% and 2 times the plan's representative contribution rate. Any qualified nonelective contribution taken into account in an ADP test under §1.401(k)-2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(k)-2(a)(6)(iv)(B)) is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate for purposes of paragraph (a)(6)(v)(B) of this section).

(B) Definition of representative contribution rate. For purposes of this paragraph (a)(6)(v), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the applicable year and who is employed by the employer on the last day of the applicable year).

(C) Definition of applicable contribution rate. For purposes of this paragraph (a)(6)(v), the applicable contribution rate for an eligible NHCE is the sum of the matching contributions taken into account under this section for the employee for the plan year and the qualified nonelective contributions made for that employee for the plan year, divided by that employee's compensation for the same period.

(vi) Contribution only used once. Qualified nonelective contributions can not be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ACP test, any ADP test, or the requirements of §1.401(k)-3, 1.401(m)-3 or 1.401(k)-4. Thus, for example, qualified nonelective contributions that are made pursuant to §1.401(k)-3(b) cannot be taken into account under the ACP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(m)-2(c)(1), qualified nonelective contributions that are taken into account under the current year testing method for a plan year may not be taken into account under the prior year testing method for the next plan year.

(7) Examples. The following examples illustrate the application of this paragraph (a). See §1.401(k)-2(a)(6) for additional examples of the parallel rules under section 401(k)(3)(A). The examples are as follows:

Example 1. (i) Employer L maintains Plan U, a profit-sharing plan under which $.50 matching contributions are made for each dollar of employee contributions. Plan U uses the current year testing method. The chart below shows the average employee contributions (as a percentage of compensation) and matching contributions (as a percentage of compensation) for Plan U's highly compensated employees and nonhighly compensated employees for the 2006 plan year:

	Employee Contributions	Matching Contributions	Actual Contribution Percentage
Highly compensated employees	4%	2%	6%
Nonhighly compensated employees	3%	1.5%	4.5%

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees, as shown in the following table.

(iii) Because the ACP for the HCEs (6.0%) exceeds 5.63% (4.5% x 1.25), Plan U does not satisfy the ACP test under paragraph (a)(1)(i)(A) of this section. However, because the ACP for the HCEs does not exceed the ACP for the NHCEs by more than 2 percentage points and the ACP for the HCEs does not exceed the ACP for the NHCEs multiplied by 2 (4.5% x 2 = 9%), the plan satisfies the ACP test under paragraph (a)(1)(i)(B) of this section.

Example 2. (i) Employees A through F are eligible employees in Plan V, a profit-sharing plan of Employer M that includes a cash or deferred arrangement and permits employee contributions. Under Plan V, a $.50 matching contribution is made for each dollar of elective contributions and employee contributions. Plan V uses the current year testing method and does not provide for elective contributions to be taken into account in determining an eligible employee's ACR. For the 2006 plan year, Employees A and B are HCEs and the remaining employees are NHCEs. The compensation, elective contributions, employee contributions, and matching contributions for the 2006 plan year are shown in the following table:

Employee	Compensation	Elective Contributions	Employee Contributions	Matching Contributions
A	$190,000	$15,000	$3,500	$9,250
B	100,000	$ 5,000	$10,000	$7,500
C	85,000	$12,000	$ 0	$6,000
D	70,000	$ 9,500	$ 0	$4,750
E	40,000	$ 10,000	$ 0	$5,000
F	10,000	$ 0	$ 0	$ 0

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees, as shown in the following table:

Employee	Compensation	Employee Contributions	Matching Contributions	ACR %
A	$190,000	$3,500	$9,250	6.71
B	100,000	$10,000	$7,500	17.50
C	85,000	$ 0	$6,000	7.06
D	70,000	$ 0	$4,750	6.79
E	40,000	$ 0	$ 5,000	12.50
F	10,000	$ 0	$ 0	0

(iii) The ACP for the HCEs is 12.11% ((6.71% + 17.50%)/2). The ACP for the

NHCEs is 6.59% ((7.06% + 6.79% + 12.50% + 0.%)/4). Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(A) of this section because the ACP of highly compensated employees is more than 125% of the ACP of the nonhighly compensated employees (6.59% × 1.25 = 8.24%). In addition, Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(B) of this section because the ACP for the HCEs exceeds the ACP of the other employees by more than 2 percentage points (6.59% + 2% = 8.59%). Therefore, the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

Example 3. (i) The facts are the same as Example 2, except that the plan provides that the nonhighly compensated employees' elective contributions may be used to meet the requirements of section 401(m) to the extent needed under that section.

(ii) Pursuant to paragraph (a)(6)(ii) of this section, the $10,000 of elective contributions for Employee E may be taken into account in determining the ACP rather than the ADP to the extent that the plan satisfies the requirements of §1.401(k)-2(a)(1) excluding from the ADP this $10,000. In this case, if the $10,000 were excluded from the ADP for the NHCEs, the ADP for the highly compensated employees is 6.45% (7.89% + 5.00%) /2 and the ADP for the nonhighly compensated employees would be 6.92% (14.12% + 13.57% + 0% +0%)/4) and the plan would satisfy the requirements of §1.401(k)-2(a)(1) excluding from the ADP the elective contributions for NHCEs that are taken into account under section 401(m).

(iii) After taking into account the $10,000 of elective contributions for Employee E in the ACP test, the ACP for the nonhighly compensated employees is 12.84% (7.06% + 6.79% + 37.50 % + 0%) /4. Therefore the plan satisfies the ACP test because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the nonhighly compensated employees.

Example 4. (i) The facts are the same as Example 2, except that Plan V provides for a higher than 50% match rate on the elective contributions and employee contributions for all NHCEs. The match rate is defined as the rate, rounded up to the next whole percent, necessary to allow the plan to satisfy the ACP test, but not in excess of 100%. In this case, an increase in the match rate from 50% to 74% will be sufficient to allow the plan to satisfy the ACP test. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions at a 74% match rate of the eligible NHCEs (employees C through F) are shown in the following table:

Employee	Compensation	Elective Contributions	Employee Contributions	Matching Contributions

C	$ 85,000	$ 12,000	$ 0	$ 8,880
D	70,000	$ 9,500	$ 0	$ 7,030
E	40,000	$ 10,000	$ 0	$ 7,400
F	10,000	$ 0	$ 0	$ 0

(ii) The matching rate for all NHCEs is 74% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Therefore, the matching contributions may be taken into account in determining the ACP for the NHCEs.

(iii) The ACP for the NHCEs is 9.75% (10.45% + 10.04% + 18.50% + 0%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m).

Example 5. (i) The facts are the same as Example 4, except that: Employee E's elective contributions are $2,000 (rather than $10,000) and pursuant to paragraph (a)(6)(ii) of this section, the $2,000 of elective contributions for Employee E are taken into account in determining the ACP rather than the ADP. In addition, Plan V provides that the higher match rate is not limited to 100% and applies only for a specified group of nonhighly compensated employees. The only member of that group is Employee E. Under the plan provision, the higher match rate is a 400% match. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions of the eligible NHCEs (employees C through F) are shown in the following table:

Employee	Compensation	Elective Contributions	Employee Contributions	Matching Contributions
C	$ 85,000	$12,000	$ 0	$6,000
D	70,000	$ 9,500	$ 0	$4,750
E	40,000	$ 2,000	$ 0	$8,000
F	10,000	$ 0	$ 0	$ 0

(ii) If the entire matching contribution made on behalf of Employee E were taken into account under the ACP test, Plan V would satisfy the test, because the ACP for the NHCEs would be 9.71% (7.06% + 6.79% + 25.00% + 0%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times what the ACP for the NHCEs would be, the plan would satisfy the requirements of section 401(m).

(iii) Pursuant to paragraph (a)(5)(ii) of this section, however, matching contributions for an eligible NHCE that are based on a matching rate in excess of the greater of 100% and twice the plan's representative matching rate cannot be taken into account in applying the ACP test. The plan's representative matching rate is the lowest matching rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year who make elective contributions or employee contributions for the plan year. For Plan V, the group of NHCEs who make such contributions consists of Employees C, D and E. The matching rates for these three employees are 50%, 50% and 400% respectively. The lowest matching rate for a group of NHCEs that is at least ½ of all the NHCEs who make elective contributions or employee contributions (or 2 NHCEs) is 50%. Because 400% is more than twice the plan's representative matching rate, only the matching contributions made on behalf of Employee E that do not exceed 100% (or in this case $2,000) satisfy the requirements of paragraph (a)(5)(ii) of this section and may be taken into account under the ACP test. Accordingly, the ACP for the NHCEs is 5.96% (7.06% + 6.79% + 10% + 0%)/4 and the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

Example 6. (i) The facts are the same as Example 2, except that Plan V provides a QNEC equal to 13% of pay for Employee F that will be taken into account under the ACP test to the extent the contributions satisfy the requirements of paragraph (a)(6) of this section.

(ii) Pursuant to paragraph (a)(6)(v) of this section, a QNEC cannot be taken into account in determining an NHCE's ACR to the extent it exceeds the greater of 5% and the product of the employee's compensation and the plan's representative contribution rate. The plan's representative contribution rate is two times the lowest applicable contribution rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year. For Plan V, the applicable contribution rates for Employees C, D, E and F are 7.06%, 6.79%, 12.5% and 13% respectively. The lowest applicable rate for a group of NHCEs that is at least ½ of all the NHCEs is 12.50% (the lowest applicable rate for the group of NHCEs that consists of Employees E and F).

(iii) Under paragraph (a)(6)(v)(B) of this section, the plan's representative contribution rate is 2 times 12.50% or 25.00%. Accordingly, the QNECs for Employee F can be taken into account under the ACP test only to the extent they do not exceed 25.00% of compensation. In this case, all of the QNECs for Employee F may be taken into account under the ACP test.

(iv) After taking into account the QNECs for Employee F, the ACP for the NHCEs is 9.84% (7.06% + 6.79% + 12.50% + 13%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m)(2) and paragraph (a)(1) of this section.

(b) Correction of excess aggregate contributions--(1) Permissible correction methods--(i) In general. A plan that provides for employee contributions or matching contributions does not fail to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan, uses either of the following correction methods--

(A) Additional contributions. The employer makes additional contributions that are taken into account for the ACP test under this section that, in combination with the other contributions taken into account under this section, allow the plan to satisfy the requirements of paragraph (a)(1) of this section.

(B) Excess aggregate contributions distributed or forfeited. Excess aggregate contributions are distributed or forfeited in accordance with paragraph (b)(2) of this section.

(ii) Combination of correction methods. A plan may provide for the use of either of the correction methods described in paragraph (b)(1)(i) of this section, may limit employee contributions or matching contributions in a manner that prevents excess aggregate contributions from being made, or may use a combination of these methods, to avoid or correct excess aggregate contributions. If a plan uses a combination of correction methods, any contributions made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction method in paragraph (b)(1)(i)(B) of this section.

(iii) Exclusive means of correction. A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than one described in paragraph (b)(1)(i) or (ii) of this section. Thus, excess aggregate contributions for a plan year may not be corrected by forfeiting vested matching contributions, distributing nonvested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Similarly, excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess aggregate contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)-11(g). See §1.401(a)(4)-11(g)(3)(vii) and (5).

(2) Correction through distribution--(i) General rule. This paragraph (b)(2) contains the rules for correction of excess aggregate contributions through a distribution from the plan. Correction through a distribution generally involves a four step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess aggregate contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess aggregate contributions among the HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess aggregate contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned contributions, together with allocable income (or forfeit the apportioned matching contributions, if forfeitable) in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions.

(ii) Calculation of total amount to be distributed. The following procedures must be used to determine the total amount of the excess aggregate contributions to be distributed--

(A) Calculate the dollar amount of excess aggregate contributions for each HCE. The amount of excess aggregate contributions attributable to an HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ACR to equal the highest permitted ACR under the plan. To calculate the highest permitted ACR under a plan, the ACR of the HCE with the highest ACR is reduced by the amount required to cause that HCE's ACR to equal the ACR of the HCE with the next highest ACR. If a lesser reduction would enable the plan to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction applies.

(B) Determination of the total amount of excess aggregate contributions. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the plan would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess aggregate contributions for the plan year.

(C) Satisfaction of ACP. A plan satisfies this paragraph (b)(2)(ii)(C) if the plan would satisfy the requirements of paragraph (a)(1)(i) of this section if the ACR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) Apportionment of total amount of excess aggregate contributions among the HCEs. The following procedures must be used in apportioning the total amount of excess aggregate contributions determined under paragraph (b)(2)(ii) of this section among the HCEs--

(A) Calculate the dollar amount of excess aggregate contributions for each HCE. The contributions with respect to the HCE with the highest dollar amount of contributions taken account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of contributions taken into account under this section for the HCE with the next highest dollar amount of such contributions. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess aggregate contributions, only the lesser apportionment would apply.

(B) Limit on amount apportioned to any HCE. For purposes of this paragraph (b)(2)(iii), the contributions for an HCE who is an eligible employee in more than one plan of an employer to which matching contributions and employee contributions are made is determined by adding together all contributions otherwise taken into account in determining the ACR of the HCE under the rules of paragraph (a)(3)(ii) of this section. However, the amount of contributions apportioned with respect to an HCE must not exceed the amount of contributions taken into account under this section that were actually made on behalf of the HCE to the plan for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which employee contributions or matching contributions are made and whose ACR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount distributed under this paragraph (b)(2)(iii) will not exceed such contributions actually contributed to the plan for the plan year that are taken into account under this section for the plan year.

(C) Apportionment to additional HCEs. The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess aggregate contributions have been apportioned.

(iv) Income allocable to excess aggregate contributions--(A) General rule. The income allocable to excess aggregate contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess aggregate contributions are or will be credited with allocable gain or loss for the period after the close of the plan year (the gap period), the allocable gain or loss for the gap period.

(B) Method of allocating income. A plan may use any reasonable method for computing the income allocable to excess aggregate contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)-1(c)(8).

(C) Alternative method of allocating income for the plan year. A plan may allocate income to excess aggregate contributions for the plan year by multiplying the income for the plan year allocable to employee contributions, matching contributions and other amounts taken into account under this section (including the contributions for the year), by a fraction, the numerator of which is the excess aggregate contributions for the employee for the plan year, and the denominator of which is the account balance attributable to employee contributions and matching contributions and other amounts taken into account under this section as of the beginning of the plan year (including any additional such contributions for the plan year).

(D) Safe harbor method of allocating gap period income. A plan may use the safe harbor method in this paragraph (b)(2)(iv)(D) to determine income on excess aggregate contributions for the gap period. Under this safe harbor method, income on excess aggregate contributions for the gap period is equal to 10% of the income allocable to excess aggregate contributions for the plan year that would be determined under paragraph (b)(2)(iv)(C) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.

(E) Alternative method of allocating plan year and gap period income. A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to that aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken into account for the plan year in determining the fraction that is multiplied by that income.

(F) Allocable income for recharacterized elective contributions. If recharacterized elective contributions are distributed as excess aggregate contributions, the income allocable to the excess aggregate contributions is determined as if recharacterized elective contributions had been distributed as excess contributions. Thus, income must be allocated to the recharacterized amounts distributed using the methods in §1.401(k)-2(b)(2)(iv).

(v) Distribution and forfeiture. Within 12 months after the close of the plan year in which the excess aggregate contribution arose, the plan must distribute to each HCE the contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section (and the allocable income) to the extent they are vested or forfeit such amounts, if forfeitable. Except as otherwise provided in this paragraph (b)(2)(v), a distribution of excess aggregate contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. In the event of a complete termination of the plan during the plan year in which an excess aggregate contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of an HCE is distributed prior to when the plan makes a distribution of excess aggregate contributions in accordance with this paragraph (b)(2), the distribution is deemed to have been a corrective distribution of excess aggregate contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(vi) Tax treatment of corrective distributions--(A) General rule. Except as otherwise provided in paragraph (b)(2)(vi)(B) of this section, a corrective distribution of excess aggregate contributions (and income) that is made within 2½ months after the end of the plan year for which the excess aggregate contributions were made is includible in the employee's gross income for the taxable year of the employee ending with or within the plan year for which the excess aggregate contributions were made. A corrective distribution of excess aggregate contributions (and income) that is made more than 2½ months after the plan year for which the excess aggregate contributions were made is includible in the employee's gross income in the taxable year of the employee in which distributed. The portion of the distribution that is treated as an investment in the contract under section 72 is determined without regard to any plan contributions other than those distributed as excess aggregate contributions. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t). See paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year. See also §1.402(c)-2, A-4 prohibiting rollover of distributions that are excess aggregate contributions.

(B) Rule for de minimis distributions. If the total amount of excess aggregate contributions determined under this paragraph (b)(2), and excess contributions determined under §1.401(k)-2(b)(2) distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess aggregate contributions (and income) is includible in gross income in the recipient's taxable year in which the corrective distribution is made.

(3) Other rules--(i) No employee or spousal consent required. A distribution of excess aggregate contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(ii) Treatment of corrective distributions and forfeited contributions as employer contributions. Excess aggregate contributions (other than amounts attributable to employee contributions), including forfeited matching contributions, are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan. Forfeited matching contributions that are reallocated to the accounts of other participants for the plan year in which the forfeiture occurs are treated under section 415 as annual additions for the participants to whose accounts they are reallocated and for the participants from whose accounts they are forfeited.

(iii) No reduction of required minimum distribution. A distribution of excess aggregate contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9). See §1.401(a)(9)-5, A-9(b).

(iv) Partial correction. Any distribution of less than the entire amount of excess aggregate contributions (and allocable income) is treated as a pro rata distribution of excess aggregate contributions and allocable income.

(v) Matching contributions on excess contributions, excess deferrals and excess aggregate contributions--(A) Corrective distributions not permitted. A matching contribution may not be distributed merely because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(B) Coordination with section 401(a)(4). A matching contribution is taken into account under section 401(a)(4) even if the match is distributed, unless the distributed contribution is an excess aggregate contribution. This requires that, after correction of excess aggregate contributions, each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)-4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if employee contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the HCEs' accounts. This is because the level of matching contributions will be higher for a group of employees that consists entirely of HCEs. Under section 411(a)(3)(G) and §1.411(a)-4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions and excess deferrals to avoid a violation of section 401(a)(4). See also §1.401(a)(4)-11(g)(3)(vii)(B) regarding the use of additional allocations to the accounts of NHCEs for the purpose of correcting a discriminatory rate of matching contributions. A plan is permitted to provide for which contributions are to be distributed to satisfy the ACP test so as to avoid discriminatory matching rates that would otherwise violate section 401(a)(4). For example, the plan may provide that unmatched employee contributions will be distributed before matched employee contributions.

(vi) No requirement for recalculation. If the distributions and forfeitures described in paragraph (b)(2) of this section are made, the employee contributions and matching contributions are treated as meeting the nondiscrimination test of section 401(m)(2) regardless of whether the ACP for the HCEs, if recalculated after the distributions and forfeitures, would satisfy section 401(m)(2).

(4) Failure to timely correct--(i) Failure to correct within 2½ months after end of plan year. If a plan does not correct excess aggregate contributions within 2½ months after the close of the plan year for which the excess aggregate contributions are made, the employer will be liable for a 10% excise tax on the amount of the excess aggregate contributions. See section 4979 and §54.4979-1 of this chapter. Qualified nonelective contributions properly taken into account under paragraph (a)(6) of this section for a

plan year may enable a plan to avoid having excess aggregate contributions, even if the contributions are made after the close of the 2½ month period.

(ii) Failure to correct within 12 months after end of plan year. If excess aggregate contributions are not corrected within 12 months after the close of the plan year for which they were made, the plan will fail to meet the requirements of section 401(a)(4) for the plan year for which the excess aggregate contributions were made and all subsequent plan years in which the excess aggregate contributions remain in the trust.

(5) Examples. The following examples illustrate the application of this paragraph. See also §1.401(k)-2(b) for additional examples of the parallel correction rules applicable to cash or deferred arrangements. For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

Example 1. (i) Employer L maintains a plan that provides for employee contributions and fully vested matching contributions. The plan provides that failures of the ACP test are corrected by distribution. In 2006, the ACP for the eligible NHCEs is 6%. Thus, the ACP for the eligible HCEs may not exceed 8%. The three HCEs who participate have the following compensation, contributions, and ACRs:

Employee	Compensation	Employee contributions and matching contributions	Actual Contribution Ratio
A	200,000	14,000	7%
B	150,000	13,500	9
C	100,000	12,000	12
			Average 9.33%

(ii) The total amount of excess aggregate contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the matching and employee contributions of Employee C (the HCE with the highest ACR) is reduced by

3% of compensation (or $3,000) in order to reduce the ACR of that HCE to 9%, which is the ACR of Employee B.

(iii) Because the ACP of the HCEs determined after the $3,000 reduction still exceeds 8%, further reductions in matching contributions and employee contributions are necessary in order to reduce the ACP of the HCEs to 8%. The employee contributions and matching contributions for Employees B and C are reduced by an additional .5% of compensation or $1,250 ($750 and $500 respectively). Because the ACP of the HCEs determined after the reductions now equals 8%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess aggregate contributions ($4,250) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of matching contributions and employee contributions. Therefore, Employee A is apportioned $500 (the amount required to cause A's matching contributions and employee contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(v) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance ($3,750) of the total amount of excess aggregate contributions is apportioned equally among Employees A and B ($1,500 to each, the amount required to cause their contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(vi) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance ($750) of the total amount of excess aggregate contributions is apportioned equally among Employees A, B and C ($250 to each, the amount required to allocate the total amount of excess aggregate contributions for the plan).

(vii) Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess aggregate contributions equal to $ 2,250 ($500 + $1,500 + $250) and allocable income, Employee B receives a corrective distribution of $250 and allocable income and Employee C receives a corrective distribution of $1,750 ($1,500 + $250) and allocable income.

<u>Example 2</u>. (i) Employee D is the sole HCE who is eligible to participate in a cash or deferred arrangement maintained by Employer M. The plan that includes the arrangement, Plan X, permits employee contributions and provides a fully vested matching contribution equal to 50% of elective contributions. Plan X is a calendar year plan. Plan X corrects excess contributions by recharacterization and provides that failures of the ACP test are corrected by distribution. For the 2006 plan year, D's compensation is $200,000, and D's elective contributions are $15,000. The actual deferral percentages and actual contribution percentages for Employee D and the other

eligible employees under Plan X are shown in the following table:

	Actual Deferral Percentage	Actual Contribution Percentage
Employee D	7.5%	3.75 %
NHCEs	4 %	2%

(ii) In February 2007, Employer M determines that D's actual deferral ratio must be reduced to 6%, or $12,000, which requires a recharacterization of $3,000 as an employee contribution. This increases D's actual contribution ratio to 5.25% ($7,500 in matching contributions plus $3,000 recharacterized as employee contributions, divided by $200,000 in compensation). Since D's actual contribution ratio must be limited to 4% for Plan X to satisfy the actual contribution percentage test, Plan X must distribute 1.25% or $2,500 of D's employee contributions and matching contributions together with allocable income. If $2,500 in matching contributions and allocable income is distributed, this will correct the excess aggregate contributions and will not result in a discriminatory rate of matching contributions. See Example 8.

Example 3. (i) The facts are the same as in Example 2, except that Employee D also had elective contributions under Plan Y, maintained by an employer unrelated to M. In January 2007, D requests and receives a distribution of $1,200 in excess deferrals from Plan X. Pursuant to the terms of Plan X, D forfeits the $600 match on the excess deferrals to correct a discriminatory rate of match.

(ii) The $3,000 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by the $1,200 already distributed as an excess deferral, leaving $1,800 to be recharacterized. See §1.401(k)-2(b)(4)(i)(A). D's actual contribution ratio is now 4.35% ($7,500 in matching contributions plus $1,800 in recharacterized contributions less $600 forfeited matching contributions attributable to the excess deferrals, divided by $200,000 in compensation).

(iii) The matching and employee contributions for Employee D must be reduced by .35% of compensation in order to reduce the ACP of the HCEs to 4%. The plan must provide for forfeiture of additional matching contributions to prevent a discriminatory rate of matching contributions. See Example 8.

Example 4. (i) The facts are the same as in Example 3, except that D does not request a distribution of excess deferrals until March 2007. Employer X has already recharacterized $3,000 as employee contributions.

(ii) Under §1.402(g)-1(e)(6), the amount of excess deferrals is reduced by the amount of excess contributions that are recharacterized. Because the amount recharacterized is greater than the excess deferrals, Plan X is neither required nor permitted to make a distribution of excess deferrals, and the recharacterization has corrected the excess deferrals.

Example 5. (i) For the 2006 plan year, Employee F defers $10,000 under Plan M and $6,000 under Plan N. Plans M and N, which have calendar plan years are maintained by unrelated employers. Plan M provides a fully vested, 100% matching contribution, does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k) and provides that excess contributions and excess aggregate contributions are corrected by distribution. Under Plan M, Employee F is allocated excess contributions of $600 and excess aggregate contributions of $1,600. Employee F timely requests and receives a distribution of the $1,000 excess deferral from Plan M and, pursuant to the terms of Plan M, forfeits the corresponding $1,000 matching contribution.

(ii) No distribution is required or permitted to correct the excess contributions because $1,000 has been distributed by Plan M as excess deferrals. The distribution required to correct the excess aggregate contributions (after forfeiting the matching contribution) is $600 ($1,600 in excess aggregate contributions minus $1,000 in forfeited matching contributions). If Employee F had corrected the excess deferrals of $1,000 by withdrawing $1,000 from Plan N, Plan M would have had to correct the $600 excess contributions in Plan M by distributing $600. Since Employee F then would have forfeited $600 (instead of $1,000) in matching contributions, Employee F would have had $1,000 ($1,600 in excess aggregate contributions minus $600 in forfeited matching contributions) remaining of excess aggregate contributions in Plan M. These would have been corrected by distributing an additional $1,000 from Plan M.

Example 6. (i) Employee G is the sole highly compensated employee in a profit sharing plan under which the employer matches 100% of employee contributions up to 2% of compensation, and 50% of employee contributions up to the next 4% of compensation. For the 2008 plan year, Employee G has compensation of $100,000 and makes a 7% employee contribution of $7,000. Employee G receives a 4% matching contribution or $4,000. Thus, Employee G's actual contribution ratio (ACR) is 11%. The actual contribution percentage for the nonhighly compensated employees is 5%, and the employer determines that Employee G's ACR must be reduced to 7% to comply with the rules of section 401(m).

(ii) In this case, the plan satisfies the requirements of section if it distributes the unmatched employee contributions of $1,000, and $2,000 of matched employee contributions with their related matches of $1,000. This would leave Employee G with 4% employee contributions, and 3% matching contributions, for an ACR of 7%. Alternatively, the plan could distribute all matching contributions and satisfy this section. However, the plan could not distribute $4,000 of Employee G's employee contributions without forfeiting the related matching contributions because this would result in a discriminatory rate of matching contributions. See also Example 7.

Example 7. (i) Employee H is an HCE in Employer X's profit sharing plan, which matches 100% of employee contributions up to 5% of compensation. The matching contribution is vested at the rate of 20% per year. In 2006, Employee H makes $5,000 in employee contributions and receives $5,000 of matching contributions. Employee H is 60% vested in the matching contributions at the end of the 2006 plan year. In February 2007, Employer X determines that Employee H has excess aggregate contributions of $1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(ii) Employer X has two options available in distributing Employee H's excess contributions. The first option is to distribute $600 of vested matching contributions and forfeit $400 of nonvested matching contributions. These amounts are in proportion to Employee H's vested and nonvested interests in all matching contributions. The second option is to distribute $1,000 of vested matching contributions, leaving the nonvested matching contributions in the plan.

(iii) If the second option is chosen, the plan must also provide a separate vesting schedule for vesting these nonvested matching contributions. This is necessary because the nonvested matching contributions must vest as rapidly as they would have had no distribution been made. Thus, 50% must vest in each of the next 2 years.

(iv) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are distributed because the effect is that matching contributions for HCEs vest more rapidly than those for NHCEs. See §1.401(m)-1(e)(4).

Example 8. (i) Employer Y maintains a calendar year profit sharing plan that includes a cash or deferred arrangement. Elective contributions are matched at the rate of 100%. After-tax employee contributions are permitted under the plan only for nonhighly compensated employees and are matched at the same rate. No employees make excess deferrals. Employee J, a highly compensated employee, makes an $8,000 elective contribution and receives an $8,000 matching contribution.

(ii) Employer Y performs the actual deferral percentage (ADP) and the actual contribution percentage (ACP). To correct failures of the ADP and ACP tests, the plan distributes to A $1,000 of excess contributions and $500 of excess aggregate contributions. After the distributions, Employee J's contributions for the year are $7,000 of elective contributions and $7,500 of matching contributions. As a result, Employee J has received a higher effective rate of matching contributions than nonhighly compensated employees ($7,000 of elective contributions matched by $7,500 is an effective matching rate of 107 percent). If this amount remains in Employee J's account without correction, it will cause the plan to fail to satisfy section 401(a)(4), because only a highly compensated employee receives the higher matching contribution rate. The remaining $500 matching contribution may be forfeited (but not distributed) under section 411(a)(3)(G), if the plan so provides. The plan could instead correct the discriminatory rate of matching contributions by making additional allocations to the accounts of nonhighly compensated employees. See §1.401(a)(4)-11(g)(3)(vii)(B) and (6), Example 7.

(c) Additional rules for prior year testing method--(1) Rules for change in testing method. A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in §1.401(k)-2(c)(1)(ii). For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(m)-3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year

(2) Calculation of ACP under the prior year testing method for the first plan year--(i) Plans that are not successor plans. If, for the first plan year of any plan (other than a successor plan), a plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ACP for the eligible NHCEs, or 3% as the ACP for eligible NHCEs, for applying the ACP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year for determining the ACP for the eligible NHCEs is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) First plan year defined. For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for employee contributions or matching contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)-7) for a plan year if for such plan year the plan is aggregated under §1.401(m)-1(b)(4) with any other plan that provides for employee or matching contributions in the prior year.

(iii) Plans that are successor plans. A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under another plan maintained by the employer in the prior year that provides for employee contributions or matching contributions. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ACP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) Plans using different testing methods for the ACP and ADP test. Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ACP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ADP test for that year. For example, a plan may use the prior year testing method for the ACP test and the current year testing method for its ADP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use --

(i) The recharacterization method of §1.401(k)-2(b)(3) to correct excess contributions for a plan year;

(ii) The rules of paragraph (a)(6)(ii) of this section to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph §1.401(k)-2(a)(6) to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) Rules for plan coverage change--(i) In general. A plan that uses the prior year testing method that experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ACP for the NHCEs for the plan year is the weighted average of the ACPs for the prior year subgroups.

(ii) Optional rule for minor plan coverage changes. If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ACP for the group of eligible NHCEs for the prior year under the plan is the ACP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) Definitions. The following definitions apply for purposes of this paragraph (c)(4)--

(A) Plan coverage change. The term plan coverage change means a change in the group or groups of eligible employees under a plan on account of--

(1) The establishment or amendment of a plan;

(2) A plan merger or spinoff under section 414(l);

(3) A change in the way plans (within the meaning of §1.410(b)-7) are combined or separated for purposes of §1.401(m)-1(b)(4) (e.g., permissively aggregating plans not previously aggregated under §1.410(b)-7(d), or ceasing to permissively aggregate plans under §1.410(b)-7(d));

(4) A reclassification of a substantial group of employees that has the same effect as amending the plan (e.g., a transfer of a substantial group of employees from

one division to another division); or

(5) A combination of any of paragraphs (c)(4)(iii)(A)(1) through (4) of this section.

(B) Prior year subgroup. The term prior year subgroup means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan that provides for employee contributions or matching contributions maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) Weighted average of the ACPs for the prior year subgroups. The term weighted average of the ACPs for the prior year subgroups means the sum, for all prior year subgroups, of the adjusted ACPs for the plan year. The term adjusted ACP with respect to a prior year subgroup means the ACP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) Example. The following example illustrate the application of this paragraph (c)(4). See also §1.401(k)-2(c)(4) for examples of the parallel rules applicable to the ADP test. The example is as follows:

Example. (i) Employer B maintains two plans, Plan N and Plan P, each of which includes a provides for employee contributions or matching contributions. The plans were not permissively aggregated under § 1.410(b)-7(d) for the 2005 testing year. Both plans use the prior year testing method. Plan N had 300 eligible employees who were NHCEs for 2005, and their ACP for that year was 6%. Plan P had 100 eligible employees who were NHCEs for 2005, and the ACP for those NHCEs for that plan was 4%. Plan N and Plan P are permissively aggregated under § 1.410(b)-7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 2006 testing year under § 1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan NP). Therefore, the prior year ACP for the NHCEs under Plan NP for the 2006 testing year is the weighted average of the ACPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ACPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 2006 testing year, an employee is a member of a prior year subgroup if the employee was an NHCE of Employer B for the 2005 plan year, was an eligible employee for the 2005 plan year under any section 401(k) plan maintained by Employer B, and would have been an eligible employee in the 2005 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under §1.410(b)-7(d) for that plan year. The NHCEs who were eligible employees under separate plans for the 2005 plan year comprise separate prior year subgroups. Thus, there are two prior year subgroups under Plan NP for the 2006 testing year: the 300 NHCEs who were eligible employees under Plan N for the 2005 plan year and the 100 NHCEs who were eligible employees under Plan P for the 2005 plan year.

(iv) The weighted average of the ACPs for the prior year subgroups is the sum of the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows: 6% (the ACP for the NHCEs under Plan N for the prior year) x 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows: 4% (the ACP for the NHCEs under Plan P for the prior year) x 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 1%. Thus, the prior year ACP for NHCEs under Plan NP for the 2006 testing year is 5.5% (the sum of adjusted ACPs for the prior year subgroups, 4.5% plus 1%).

§1.401(m)-3 Safe harbor requirements.

(a) ACP test safe harbor. Matching contributions under a plan satisfy the ACP safe harbor provisions of section 401(m)(11) for a plan year if the plan satisfies the safe harbor contribution requirement of paragraphs (b) or (c) of this section for the plan year, the limitations on matching contributions of paragraph (d) of this section, the notice requirement of paragraph (e) of this section, the plan year requirements of paragraph (f) of this section, and the additional rules of paragraphs (g), (h) and (j) of this section, as applicable. Pursuant to section 401(k)(12)(E)(ii), the safe harbor contribution requirement of paragraphs (b) and (c) of this section must be satisfied without regard to section 401(l). The contributions made under paragraphs (b) and (c) of this section are referred to as safe harbor nonelective contributions and safe harbor matching contributions, respectively.

(b) Safe harbor nonelective contribution requirement. A plan satisfies the safe harbor nonelective contribution requirement of this paragraph (b) if it satisfies the safe harbor nonelective contribution requirement of §1.401(k)-3(b).

(c) Safe harbor matching contribution requirement. A plan satisfies the safe harbor matching contribution requirement of this paragraph (c) if it satisfies the safe harbor matching contribution requirement of §1.401(k)-3(c).

(d) Limitation on contributions–(1) General rule. A plan that provides for matching contributions meets the requirements of this section only if it satisfies the limitations on contributions set forth in this paragraph (d).

(2) Matching rate must not increase. A plan that provides for matching contributions meets the requirements of this paragraph (d) only if the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective deferrals and employee contributions, does not increase as the amount of an employee's elective deferrals and employee contributions increases.

(3) Limit on matching contributions. A plan that provides for matching contributions satisfies the requirements of this section only if--

(i) Matching contributions are not made with respect to elective deferrals or employee contributions that exceed 6% of the employee's safe harbor compensation (within the meaning of §1.401(k)-3(b)(2)); and

(ii) Matching contributions that are discretionary do not exceed 4% of the employee's safe harbor compensation.

(4) Limitation on rate of match. A plan meets the requirements of this section only if the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) for that plan year is no greater than the ratio of matching contributions to elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) that would apply with respect to any NHCE for whom the elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) are the same percentage of safe harbor compensation. An employee is taken into account for purposes of this paragraph (d)(4) if the employee is

an eligible employee under the cash or deferred arrangement with respect to which the contributions required by paragraph (b) or (c) of this section are being made for a plan year. A plan will not fail to satisfy this paragraph (d)(4) merely because the plan provides that matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that matching contributions with respect to any elective deferrals or employee contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(5) HCEs participating in multiple plans. The rules of section 401(m)(2)(B) and §1.401(m)-2(a)(3)(ii) apply for purposes of determining the rate of matching contributions under paragraph (d)(4) of this section. However, a plan will not fail to satisfy the safe harbor matching contribution requirements of this section merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that --

(i) The HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and

(ii) The period used to determine compensation for purposes of determining matching contributions under each such plan is limited to periods when the HCE participated in the plan.

(6) Permissible restrictions on elective deferrals by NHCEs--(i) General rule. A plan does not satisfy the safe harbor requirements of this section, if elective deferrals or employee contributions by NHCEs are restricted, unless the restrictions are permitted

by this paragraph (d)(6).

(ii) Restrictions on election periods. A plan may limit the frequency and duration of periods in which eligible employees may make or change contribution elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (e) of this section) to make or change a contribution election for the plan year. For purposes of this section, a 30-day period is deemed to be a reasonable period to make or change a contribution election.

(iii) Restrictions on amount of contributions. A plan is permitted to limit the amount of contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (d)(6)(v) of this section) to make contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of contributions. However, a plan may require eligible employees to make contribution elections in whole percentages of compensation or whole dollar amounts.

(iv) Restrictions on types of compensation that may be deferred. A plan may limit the types of compensation that may be deferred or contributed by an eligible employee under a plan, provided that each eligible NHCE is permitted to make contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)-1(d)(2). Thus, the definition of compensation from which contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)-1(d)(3).

(v) Restrictions due to limitations under the Internal Revenue Code. A plan may limit the amount of contributions made by an eligible employee under a plan--

(A) Because of the limitations of section 402(g) or section 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make contributions has been suspended for 6 months in accordance with §1.401(k)-1(d)(3)(iv)(E).

(e) Notice requirement. A plan satisfies the notice requirement of this paragraph (e) if it satisfies the notice requirement of §1.401(k)-3(d).

(f) Plan year requirement --(1) General rule. Except as provided in this paragraph (f) or in paragraph (g) of this section, a plan will fail to satisfy the requirements of section 401(m)(11) and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of that plan year and remain in effect for an entire 12-month plan year. Moreover, if, as described in paragraph (j)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions specifying that the safe harbor contributions will be made in the other plan and providing that the contributions will be QNECs or QMACs must be also be adopted before the first day of that plan year.

(2) Initial plan year. A newly established plan (other than a successor plan within the meaning of §1.401(m)-2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (f) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes

into existence, a shorter period). Similarly, a plan will not fail to satisfy the requirements of this paragraph (f) for the first plan year in which matching contributions are provided under the plan provided that--

(i) The plan is not a successor plan; and

(ii) The amendment providing for matching contributions is made effective at the same time as the adoption of a cash or deferred arrangement that satisfies the requirements of §1.401(k)-3, taking into account the rules of §1.401(k)-3(e)(2).

(3) Change of plan year. A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the plan year has less than 12 months, provided that--

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section for the immediately following plan year.

(4) Final plan year. A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the final plan year is less than 12 months, provided that--

(i) The plan would satisfy the requirements of paragraph (h) of this section, treating the termination of the plan as a reduction or suspension of safe harbor matching contributions, other than the requirement that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections; or

(ii) The plan termination is in connection with a transaction described in section

410(b)(6)(C) or the employer incurs a substantial business hardship, comparable to a substantial business hardship described in section 412(d).

(g) Plan amendments adopting nonelective safe harbor contributions. Notwithstanding paragraph (f)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section using nonelective contributions under paragraph (b) of this section if the plan satisfies the requirements of §1.401(k)-3(f).

(h) Permissible reduction or suspension of safe harbor matching contributions--(1) General rule. A plan that provides for safe harbor matching contributions will not fail to satisfy the requirements of section 401(m)(2) for a plan year merely because the plan is amended during a plan year to reduce or suspend safe harbor matching contributions on future elective deferrals and, if applicable, employee contributions provided--

(i) All eligible employees are provided the supplemental notice in accordance with paragraph (h)(2) of this section;

(ii) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of 30 days after eligible employees are provided the notice described in paragraph (h)(2) of this section and the date the amendment is adopted;

(iii) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(iv) The plan is amended to provide that the ACP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(m)-2(a)(1)(ii); and

(v) The plan satisfies the requirements of this section (other than this paragraph (h)) with respect to amounts deferred through the effective date of the amendment.

(2) Notice of suspension requirement. The notice of suspension requirement of this paragraph (h)(2) is satisfied if each eligible employee is given a written notice that satisfies the content requirements of §1.401(k)-3(e)(3).

(i) [Reserved]

(j) Other rules--(1) Contributions taken into account. A contribution is taken into account for purposes of this section for a plan year under the same rules as §1.401(k)-3(h)(1).

(2) Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests. A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies section 401(a)(4) under the same rules as §1.401(k)-3(h)(2).

(3) Early participation rules. Section 401(m)(5)(C) and §1.401(m)-2(a)(1)(iii)(A) which provide an alternative nondiscrimination rule for certain plans that provide for early participation, does not apply for purposes of section 401(m)(11) and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees.

(4) Satisfying safe harbor contribution requirement under another defined contribution plan. Safe harbor matching or nonelective contributions may be made to another defined contribution plan under the same rules as §1.401(k)-3(h)(4). Consequently, each NHCE under the plan providing for matching contributions must be eligible under the same conditions under the other defined contribution plan and the plan to which the contributions are made must have the same plan year as the plan providing for matching contributions.

(5) Contributions used only once. Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

(6) Plan must satisfy ACP with respect to employee contributions. If the plan provides for employee contributions, in addition to satisfying the requirements of this section, it must also satisfy the ACP test of §1.401(m)-2. See §1.401(m)-2(a)(5)(iii) for specials rules under which the ACP test is permitted to be run taking into account only employee contributions when this section is satisfied with respect to the matching contributions.

§1.401(m)-4 Special rules for mergers, acquisitions and similar events. *[Reserved]*

§1.401(m)-5 Definitions.

Unless otherwise provided, the definitions of this section govern for purposes of section 401(m) and the regulations thereunder.

Actual contribution percentage (ACP). Actual contribution percentage or ACP means the ACP of the group of eligible employees as defined in §1.401(m)-2(a)(2)(i).

Actual contribution percentage (ACP) test. Actual contribution percentage test or

ACP test means the test described in §1.401(m)-2(a)(1).

Actual contribution ratio (ACR). Actual contribution ratio or ACR means the ACR of an eligible employee as defined in §1.401(m)-2(a)(3).

Actual deferral percentage (ADP) test. Actual deferral percentage test or ADP test means the test described in §1.401(k)-2(a)(1).

Compensation. Compensation means compensation as defined in section 414(s) and §1.414(s)-1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year. A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year. See also section 401(a)(17) and §1.401(a)(17)-1(c)(1). For this purpose, in case of an HCE whose ACR is determined under §1.401(m)-2(a)(3)(ii), period of participation includes periods under another plan for which matching contributions or employee contributions are aggregated under §1.401(m)-2(a)(3)(ii).

Current year testing method. Current year testing method means the testing method under which the applicable year is the current plan year, as described in §1.401(m)-2(a)(2)(ii) or 1.401(k)-2(a)(2)(ii).

Elective contributions. Elective contributions means elective contributions as defined in §1.401(k)-6.

Elective deferrals. Elective deferrals means elective deferrals described in section 402(g)(3).

Eligible employee--(1) General rule. Eligible employee means an employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures) under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make an employee contribution for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs these acts.

(2) Conditions on eligibility. An employee who is unable to make employee contributions or to receive an allocation of matching contributions because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make an employee contribution or to receive an allocation of matching contributions for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. An employee who would be eligible to make employee contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(m) for a plan year even though the employee may not make employee contributions or receive an allocation of matching contributions by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1).

(3) Certain one-time elections. An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible under any plan of the employer providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee in fact does elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. In no event is an election made after December 23, 1994, treated as one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

Eligible HCE. Eligible HCE means an eligible employee who is an HCE.

Eligible NHCE. Eligible NHCE means an eligible employee who is not an HCE.

Employee. Employee means an employee within the meaning of §1.410(b)-9.

Employee contributions. Employee contributions means employee contributions as defined in 1.401(m)-1(a)(3).

Employee stock ownership plan (ESOP). Employee stock ownership plan or ESOP means the portion of a plan that is an ESOP within the meaning of §1.410(b)-7(c)(2).

Employer. Employer means an employer within the meaning of §1.410(b)-9.

Excess aggregate contributions. Excess aggregate contributions means, with respect to a plan year, the amount of excess aggregate contributions apportioned to an HCE under §1.401(m)-2(b)(2)(iii).

Excess contributions. Excess contribution means with respect to a plan year, the amount of excess contribution apportioned to an HCE under §1.401(k)-2(b)(2)(iii).

Excess deferrals. Excess deferrals means excess deferrals as defined in §1.402(g)-1(e)(3).

Highly compensated employee (HCE). Highly compensated employee or HCE has the meaning provided in section 414(q).

Matching contributions. Matching contribution is defined in §1.401(m)-1(a)(2).

Nonelective contributions. Nonelective contributions means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

Non-employee stock ownership plan (non-ESOP). Non-employee stock ownership plan or non-ESOP means the portion of a plan that is not an ESOP within the meaning of §1.410(b)-7(c)(2).

Non-highly compensated employee (NHCE). Non-highly compensated employee or NHCE means an employee who is not an HCE.

Plan. Plan means plan as defined in §1.401(m)-1(b)(4).

Prior year testing method. Prior year testing method means the testing method under which the applicable year is the prior plan year, as described in §1.401(m)-2(a)(2)(ii) or §1.401(k)-2(a)(2)(ii).

Qualified matching contributions (QMAC). Qualified matching contributions or QMAC means matching contributions that satisfy the requirements of §1.401(k)-1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account as elective contributions under §1.401(k)-2(a)(6). See also §1.401(k)-2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) because it is a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

Qualified nonelective contributions (QNEC). Qualified nonelective contributions or QNEC means employer contributions, other than elective contributions or matching contributions, that satisfy the requirements of §1.401(k)-1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)-2(a)(6) or the ADP test under §1.401(m)-2(a)(6).

Judith B. Tomaso,

Acting Deputy Commissioner for Services and Enforcement.

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

FOR IMMEDIATE RELEASE
July 16, 2003

Contact: Office of Financing
(202) 691-3550

TREASURY'S INFLATION-INDEXED SECURITIES AUGUST REFERENCE CPI NUMBERS AND DAILY INDEX RATIOS

Public Debt announced today the reference Consumer Price Index (CPI) numbers and daily index ratios for the month of August for the following Treasury inflation-indexed securities:
(1) 3-3/8% 10-year notes due January 15, 2007
(2) 3-5/8% 10-year notes due January 15, 2008
(3) 3-5/8% 30-year bonds due April 15, 2028
(4) 3-7/8% 10-year notes due January 15, 2009
(5) 3-7/8% 30-year bonds due April 15, 2029
(6) 4-1/4% 10-year notes due January 15, 2010
(7) 3-1/2% 10-year notes due January 15, 2011
(8) 3-3/8% 30-1/2-year bonds due April 15, 2032
(9) 3-3/8% 10-year notes due January 15, 2012
(10) 3% 10-year notes due July 15, 2012
(11) 1-7/8% 10-year notes due July 15, 2013

This information is based on the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U) published by the Bureau of Labor Statistics of the U.S. Department of Labor.

In addition to the publication of the reference CPI's (Ref CPI) and index ratios, this release provides the non-seasonally adjusted CPI-U for the prior three-month period.

The information for September is expected to be released on August 15, 2003.

o0o

August Reference CPI Numbers and Daily Index Ratios Table PDF format (file size-16KB, uploaded-07/16/03)

JS-568

3-3/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2007

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2007
CUSIP NUMBER:	9128272M3
DATED DATE:	January 15, 1997
ORIGINAL ISSUE DATE:	February 6, 1997
ADDITIONAL ISSUE DATE:	April 15, 1997
MATURITY DATE:	January 15, 2007
Ref CPI on DATED DATE:	158.43548
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.15820
August	2	2003	183.50645	1.15824
August	3	2003	183.51290	1.15828
August	4	2003	183.51935	1.15832
August	5	2003	183.52581	1.15836
August	6	2003	183.53226	1.15840
August	7	2003	183.53871	1.15844
August	8	2003	183.54516	1.15849
August	9	2003	183.55161	1.15853
August	10	2003	183.55806	1.15857
August	11	2003	183.56452	1.15861
August	12	2003	183.57097	1.15865
August	13	2003	183.57742	1.15869
August	14	2003	183.58387	1.15873
August	15	2003	183.59032	1.15877
August	16	2003	183.59677	1.15881
August	17	2003	183.60323	1.15885
August	18	2003	183.60968	1.15889
August	19	2003	183.61613	1.15893
August	20	2003	183.62258	1.15897
August	21	2003	183.62903	1.15901
August	22	2003	183.63548	1.15906
August	23	2003	183.64194	1.15910
August	24	2003	183.64839	1.15914
August	25	2003	183.65484	1.15918
August	26	2003	183.66129	1.15922
August	27	2003	183.66774	1.15926
August	28	2003	183.67419	1.15930
August	29	2003	183.68065	1.15934
August	30	2003	183.68710	1.15938
August	31	2003	183.69355	1.15942

3-5/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2008

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2008
CUSIP NUMBER:	9128273T7
DATED DATE:	January 15, 1998
ORIGINAL ISSUE DATE:	January 15, 1998
ADDITIONAL ISSUE DATE:	October 15, 1998
MATURITY DATE:	January 15, 2008
Ref CPI on DATED DATE:	161.55484
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.13584
August	2	2003	183.50645	1.13588
August	3	2003	183.51290	1.13592
August	4	2003	183.51935	1.13596
August	5	2003	183.52581	1.13600
August	6	2003	183.53226	1.13604
August	7	2003	183.53871	1.13608
August	8	2003	183.54516	1.13612
August	9	2003	183.55161	1.13616
August	10	2003	183.55806	1.13620
August	11	2003	183.56452	1.13624
August	12	2003	183.57097	1.13628
August	13	2003	183.57742	1.13632
August	14	2003	183.58387	1.13636
August	15	2003	183.59032	1.13640
August	16	2003	183.59677	1.13644
August	17	2003	183.60323	1.13648
August	18	2003	183.60968	1.13652
August	19	2003	183.61613	1.13656
August	20	2003	183.62258	1.13660
August	21	2003	183.62903	1.13664
August	22	2003	183.63548	1.13668
August	23	2003	183.64194	1.13672
August	24	2003	183.64839	1.13676
August	25	2003	183.65484	1.13680
August	26	2003	183.66129	1.13684
August	27	2003	183.66774	1.13688
August	28	2003	183.67419	1.13692
August	29	2003	183.68065	1.13696
August	30	2003	183.68710	1.13700
August	31	2003	183.69355	1.13704

3-5/8% TREASURY 30-YEAR INFLATION-INDEXED BONDS
Due April 15, 2028

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Bonds of April 2028
CUSIP NUMBER:	912810FD5
DATED DATE:	April 15, 1998
ORIGINAL ISSUE DATE:	April 15, 1998
ADDITIONAL ISSUE DATE:	July 15, 1998
MATURITY DATE:	April 15, 2028
Ref CPI on DATED DATE:	161.74000
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.13454
August	2	2003	183.50645	1.13458
August	3	2003	183.51290	1.13462
August	4	2003	183.51935	1.13466
August	5	2003	183.52581	1.13470
August	6	2003	183.53226	1.13474
August	7	2003	183.53871	1.13478
August	8	2003	183.54516	1.13482
August	9	2003	183.55161	1.13486
August	10	2003	183.55806	1.13490
August	11	2003	183.56452	1.13494
August	12	2003	183.57097	1.13498
August	13	2003	183.57742	1.13502
August	14	2003	183.58387	1.13506
August	15	2003	183.59032	1.13510
August	16	2003	183.59677	1.13514
August	17	2003	183.60323	1.13518
August	18	2003	183.60968	1.13522
August	19	2003	183.61613	1.13525
August	20	2003	183.62258	1.13529
August	21	2003	183.62903	1.13533
August	22	2003	183.63548	1.13537
August	23	2003	183.64194	1.13541
August	24	2003	183.64839	1.13545
August	25	2003	183.65484	1.13549
August	26	2003	183.66129	1.13553
August	27	2003	183.66774	1.13557
August	28	2003	183.67419	1.13561
August	29	2003	183.68065	1.13565
August	30	2003	183.68710	1.13569
August	31	2003	183.69355	1.13573

3-7/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES Due January 15, 2009

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2009
CUSIP NUMBER:	9128274Y5
DATED DATE:	January 15, 1999
ORIGINAL ISSUE DATE:	January 15, 1999
ADDITIONAL ISSUE DATE:	July 15, 1999
MATURITY DATE:	January 15, 2009
Ref CPI on DATED DATE:	164.00000
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.11890
August	2	2003	183.50645	1.11894
August	3	2003	183.51290	1.11898
August	4	2003	183.51935	1.11902
August	5	2003	183.52581	1.11906
August	6	2003	183.53226	1.11910
August	7	2003	183.53871	1.11914
August	8	2003	183.54516	1.11918
August	9	2003	183.55161	1.11922
August	10	2003	183.55806	1.11926
August	11	2003	183.56452	1.11930
August	12	2003	183.57097	1.11934
August	13	2003	183.57742	1.11937
August	14	2003	183.58387	1.11941
August	15	2003	183.59032	1.11945
August	16	2003	183.59677	1.11949
August	17	2003	183.60323	1.11953
August	18	2003	183.60968	1.11957
August	19	2003	183.61613	1.11961
August	20	2003	183.62258	1.11965
August	21	2003	183.62903	1.11969
August	22	2003	183.63548	1.11973
August	23	2003	183.64194	1.11977
August	24	2003	183.64839	1.11981
August	25	2003	183.65484	1.11985
August	26	2003	183.66129	1.11989
August	27	2003	183.66774	1.11993
August	28	2003	183.67419	1.11996
August	29	2003	183.68065	1.12000
August	30	2003	183.68710	1.12004
August	31	2003	183.69355	1.12008

3-7/8% TREASURY 30-YEAR INFLATION-INDEXED BONDS
Due April 15, 2029

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Bonds of April 2029
CUSIP NUMBER:	912810FH6
DATED DATE:	April 15, 1999
ORIGINAL ISSUE DATE:	April 15, 1999
ADDITIONAL ISSUE DATES:	October 15, 1999 October 15, 2000
MATURITY DATE:	April 15, 2029
Ref CPI on DATED DATE:	164.39333
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.11623
August	2	2003	183.50645	1.11626
August	3	2003	183.51290	1.11630
August	4	2003	183.51935	1.11634
August	5	2003	183.52581	1.11638
August	6	2003	183.53226	1.11642
August	7	2003	183.53871	1.11646
August	8	2003	183.54516	1.11650
August	9	2003	183.55161	1.11654
August	10	2003	183.55806	1.11658
August	11	2003	183.56452	1.11662
August	12	2003	183.57097	1.11666
August	13	2003	183.57742	1.11670
August	14	2003	183.58387	1.11674
August	15	2003	183.59032	1.11677
August	16	2003	183.59677	1.11681
August	17	2003	183.60323	1.11685
August	18	2003	183.60968	1.11689
August	19	2003	183.61613	1.11693
August	20	2003	183.62258	1.11697
August	21	2003	183.62903	1.11701
August	22	2003	183.63548	1.11705
August	23	2003	183.64194	1.11709
August	24	2003	183.64839	1.11713
August	25	2003	183.65484	1.11717
August	26	2003	183.66129	1.11721
August	27	2003	183.66774	1.11725
August	28	2003	183.67419	1.11728
August	29	2003	183.68065	1.11732
August	30	2003	183.68710	1.11736
August	31	2003	183.69355	1.11740

4-1/4% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2010

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2010
CUSIP NUMBER:	9128275W8
DATED DATE:	January 15, 2000
ORIGINAL ISSUE DATE:	January 18, 2000
ADDITIONAL ISSUE DATE:	July 17, 2000
MATURITY DATE:	January 15, 2010
Ref CPI on DATED DATE:	168.24516
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.09067
August	2	2003	183.50645	1.09071
August	3	2003	183.51290	1.09075
August	4	2003	183.51935	1.09079
August	5	2003	183.52581	1.09082
August	6	2003	183.53226	1.09086
August	7	2003	183.53871	1.09090
August	8	2003	183.54516	1.09094
August	9	2003	183.55161	1.09098
August	10	2003	183.55806	1.09102
August	11	2003	183.56452	1.09105
August	12	2003	183.57097	1.09109
August	13	2003	183.57742	1.09113
August	14	2003	183.58387	1.09117
August	15	2003	183.59032	1.09121
August	16	2003	183.59677	1.09125
August	17	2003	183.60323	1.09128
August	18	2003	183.60968	1.09132
August	19	2003	183.61613	1.09136
August	20	2003	183.62258	1.09140
August	21	2003	183.62903	1.09144
August	22	2003	183.63548	1.09148
August	23	2003	183.64194	1.09151
August	24	2003	183.64839	1.09155
August	25	2003	183.65484	1.09159
August	26	2003	183.66129	1.09163
August	27	2003	183.66774	1.09167
August	28	2003	183.67419	1.09171
August	29	2003	183.68065	1.09174
August	30	2003	183.68710	1.09178
August	31	2003	183.69355	1.09182

3-1/2% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2011

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2011
CUSIP NUMBER:	9128276R8
DATED DATE:	January 15, 2001
ORIGINAL ISSUE DATE:	January 16, 2001
ADDITIONAL ISSUE DATE:	July 16, 2001
MATURITY DATE:	January 15, 2011
Ref CPI on DATED DATE:	174.04516
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.05432
August	2	2003	183.50645	1.05436
August	3	2003	183.51290	1.05440
August	4	2003	183.51935	1.05444
August	5	2003	183.52581	1.05447
August	6	2003	183.53226	1.05451
August	7	2003	183.53871	1.05455
August	8	2003	183.54516	1.05458
August	9	2003	183.55161	1.05462
August	10	2003	183.55806	1.05466
August	11	2003	183.56452	1.05469
August	12	2003	183.57097	1.05473
August	13	2003	183.57742	1.05477
August	14	2003	183.58387	1.05481
August	15	2003	183.59032	1.05484
August	16	2003	183.59677	1.05488
August	17	2003	183.60323	1.05492
August	18	2003	183.60968	1.05495
August	19	2003	183.61613	1.05499
August	20	2003	183.62258	1.05503
August	21	2003	183.62903	1.05507
August	22	2003	183.63548	1.05510
August	23	2003	183.64194	1.05514
August	24	2003	183.64839	1.05518
August	25	2003	183.65484	1.05521
August	26	2003	183.66129	1.05525
August	27	2003	183.66774	1.05529
August	28	2003	183.67419	1.05532
August	29	2003	183.68065	1.05536
August	30	2003	183.68710	1.05540
August	31	2003	183.69355	1.05544

3-3/8% TREASURY 30-1/2-YEAR INFLATION-INDEXED BONDS Due April 15, 2032

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Bonds of April 2032
CUSIP NUMBER:	912810FQ6
DATED DATE:	October 15, 2001
ORIGINAL ISSUE DATE:	October 15, 2001
ADDITIONAL ISSUE DATE:	
MATURITY DATE:	April 15, 2032
Ref CPI on DATED DATE:	177.50000
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.03380
August	2	2003	183.50645	1.03384
August	3	2003	183.51290	1.03388
August	4	2003	183.51935	1.03391
August	5	2003	183.52581	1.03395
August	6	2003	183.53226	1.03398
August	7	2003	183.53871	1.03402
August	8	2003	183.54516	1.03406
August	9	2003	183.55161	1.03409
August	10	2003	183.55806	1.03413
August	11	2003	183.56452	1.03417
August	12	2003	183.57097	1.03420
August	13	2003	183.57742	1.03424
August	14	2003	183.58387	1.03428
August	15	2003	183.59032	1.03431
August	16	2003	183.59677	1.03435
August	17	2003	183.60323	1.03438
August	18	2003	183.60968	1.03442
August	19	2003	183.61613	1.03446
August	20	2003	183.62258	1.03449
August	21	2003	183.62903	1.03453
August	22	2003	183.63548	1.03457
August	23	2003	183.64194	1.03460
August	24	2003	183.64839	1.03464
August	25	2003	183.65484	1.03468
August	26	2003	183.66129	1.03471
August	27	2003	183.66774	1.03475
August	28	2003	183.67419	1.03478
August	29	2003	183.68065	1.03482
August	30	2003	183.68710	1.03486
August	31	2003	183.69355	1.03489

3-3/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2012

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2012
CUSIP NUMBER:	9128277J5
DATED DATE:	January 15, 2002
ORIGINAL ISSUE DATE:	January 15, 2002
MATURITY DATE:	January 15, 2012
Ref CPI on DATED DATE:	177.56452
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.03343
August	2	2003	183.50645	1.03346
August	3	2003	183.51290	1.03350
August	4	2003	183.51935	1.03354
August	5	2003	183.52581	1.03357
August	6	2003	183.53226	1.03361
August	7	2003	183.53871	1.03365
August	8	2003	183.54516	1.03368
August	9	2003	183.55161	1.03372
August	10	2003	183.55806	1.03375
August	11	2003	183.56452	1.03379
August	12	2003	183.57097	1.03383
August	13	2003	183.57742	1.03386
August	14	2003	183.58387	1.03390
August	15	2003	183.59032	1.03394
August	16	2003	183.59677	1.03397
August	17	2003	183.60323	1.03401
August	18	2003	183.60968	1.03404
August	19	2003	183.61613	1.03408
August	20	2003	183.62258	1.03412
August	21	2003	183.62903	1.03415
August	22	2003	183.63548	1.03419
August	23	2003	183.64194	1.03423
August	24	2003	183.64839	1.03426
August	25	2003	183.65484	1.03430
August	26	2003	183.66129	1.03434
August	27	2003	183.66774	1.03437
August	28	2003	183.67419	1.03441
August	29	2003	183.68065	1.03444
August	30	2003	183.68710	1.03448
August	31	2003	183.69355	1.03452

3% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due July 15, 2012

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series C-2012
CUSIP NUMBER:	912828AF7
DATED DATE:	July 15, 2002
ORIGINAL ISSUE DATE:	July 15, 2002
ADDITIONAL ISSUE DATES:	October 15, 2002 January 15, 2003
MATURITY DATE:	July 15, 2012
Ref CPI on DATED DATE:	179.80000
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	1.02058
August	2	2003	183.50645	1.02061
August	3	2003	183.51290	1.02065
August	4	2003	183.51935	1.02069
August	5	2003	183.52581	1.02072
August	6	2003	183.53226	1.02076
August	7	2003	183.53871	1.02079
August	8	2003	183.54516	1.02083
August	9	2003	183.55161	1.02087
August	10	2003	183.55806	1.02090
August	11	2003	183.56452	1.02094
August	12	2003	183.57097	1.02097
August	13	2003	183.57742	1.02101
August	14	2003	183.58387	1.02104
August	15	2003	183.59032	1.02108
August	16	2003	183.59677	1.02112
August	17	2003	183.60323	1.02115
August	18	2003	183.60968	1.02119
August	19	2003	183.61613	1.02122
August	20	2003	183.62258	1.02126
August	21	2003	183.62903	1.02130
August	22	2003	183.63548	1.02133
August	23	2003	183.64194	1.02137
August	24	2003	183.64839	1.02140
August	25	2003	183.65484	1.02144
August	26	2003	183.66129	1.02148
August	27	2003	183.66774	1.02151
August	28	2003	183.67419	1.02155
August	29	2003	183.68065	1.02158
August	30	2003	183.68710	1.02162
August	31	2003	183.69355	1.02165

1-7/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES Due July 15, 2013

Ref CPI and Index Ratios for August 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series C-2013
CUSIP NUMBER:	912828BD1
DATED DATE:	July 15, 2003
ORIGINAL ISSUE DATE:	July 15, 2003
MATURITY DATE:	July 15, 2013
Ref CPI on DATED DATE:	183.66452
TABLE FOR MONTH OF:	August 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) April 2003	183.8
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7

Month	Calendar Day	Year	Ref CPI	Index Ratio
August	1	2003	183.50000	0.99910
August	2	2003	183.50645	0.99914
August	3	2003	183.51290	0.99917
August	4	2003	183.51935	0.99921
August	5	2003	183.52581	0.99924
August	6	2003	183.53226	0.99928
August	7	2003	183.53871	0.99932
August	8	2003	183.54516	0.99935
August	9	2003	183.55161	0.99939
August	10	2003	183.55806	0.99942
August	11	2003	183.56452	0.99946
August	12	2003	183.57097	0.99949
August	13	2003	183.57742	0.99953
August	14	2003	183.58387	0.99956
August	15	2003	183.59032	0.99960
August	16	2003	183.59677	0.99963
August	17	2003	183.60323	0.99967
August	18	2003	183.60968	0.99970
August	19	2003	183.61613	0.99974
August	20	2003	183.62258	0.99977
August	21	2003	183.62903	0.99981
August	22	2003	183.63548	0.99984
August	23	2003	183.64194	0.99988
August	24	2003	183.64839	0.99991
August	25	2003	183.65484	0.99995
August	26	2003	183.66129	0.99998
August	27	2003	183.66774	1.00002
August	28	2003	183.67419	1.00005
August	29	2003	183.68065	1.00009
August	30	2003	183.68710	1.00012
August	31	2003	183.69355	1.00016

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 16, 2003
JS-569

Treasury and IRS put Common Trust Fund Straddle Tax Shelter Participants and Promoters on Notice

Today the Treasury Department and the IRS issued Notice 2003-54, which addresses tax shelters using straddles in a common trust fund entity. The Notice advises taxpayers and promoters that the transactions do not generate the tax benefits claimed by the promoters.

"Once again, Treasury and IRS have identified a tax shelter transaction that does not produce the tax benefits advertised by the promoters, and we are putting taxpayers and promoters on notice that they are subject to challenge by the IRS if the benefits are claimed on a return," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "This is another example of our continuing resolve to identify, pursue, and shut down tax shelters."

The transaction involves the use of a common trust fund (CTF) that invests in economically offsetting gain and loss positions in foreign currencies and allocates the gains to one or more tax indifferent parties and the losses to another taxpayer.

The text of Notice 2003-54 is below.

Part III - Administrative, Procedural, and Miscellaneous
Common Trust Fund Straddle Tax Shelter

Notice 2003-54

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers for the purpose of generating deductions. This notice alerts taxpayers and their representatives that the claimed tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transaction involves the use of a common trust fund (CTF) that invests in economically offsetting gain and loss positions in foreign currencies and allocates the gains to one or more tax indifferent parties and the losses to another taxpayer. For example, in the transaction, a bank (Bank) forms a CTF. The CTF's plan provides for monthly valuation dates and for the computation of income and loss on a monthly basis. Two tax indifferent investors, through grantor trusts (Investors' Trusts), each invest money in the CTF. The CTF then invests the money in economically offsetting positions in foreign currencies, which become offsetting gain and loss positions as a result of market price movements. The CTF sells the gain position and allocates the gain proportionately to the Investors' Trusts.

The next month, an investor (Taxpayer) who desires a tax loss uses a grantor trust (Taxpayer's Trust) to invest in the CTF. Taxpayer's Trust makes a large investment for an 80 percent share of the CTF. Consequently, the shares of the CTF's portfolio owned by the Investors' Trusts are diminished to 10 percent each. The CTF then sells the loss position. For tax purposes, the loss is allocated proportionately among Taxpayer's Trust and Investors' Trusts. Taxpayer's Trust is allocated 80 percent of the tax loss and Investors' Trusts are each allocated 10 percent of the tax loss under the accounting rules provided in § 1.584-2(c)(2) of the Income Tax

Regulations.

ANALYSIS

The transaction described in this notice has been designed to use economically offsetting positions, one or more tax indifferent parties, and the CTF accounting rules of § 584 of the Internal Revenue Code to allow Taxpayer to claim a noneconomic loss. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds.

The offsetting positions entered into by the CTF did not have any effect on the CTF's net economic position or non-tax objectives and did not serve any non-tax objectives of the CTF or afford it a reasonable prospect for profit. Therefore, the losses purportedly resulting from this transaction are not allowable. See ACM Partnership v. Commissioner, 157 F.3d 231, 260 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999). In addition, the Service may disallow the loss of an individual under § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. See Smith v. Commissioner, 78 T.C. 350 (1982) and Fox v. Commissioner, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions). Further, the Service may, under appropriate circumstances, assert that the CTF does not meet the requirements of § 584, including the requirement that it be operated in conformity with the rules and regulations of the Comptroller of the Currency, as set forth in 12 C.F.R. § 9.18 (2003). In that event, the Service will recharacterize such a CTF as a partnership and reallocate the gains and losses in accordance with the economics of the transaction and the interests of the participants. See § 704(b). In addition, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines.

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. The transaction described in this notice and the transactions described in Notice 2002-50, 2002-28 I.R.B. 98 (Partnership Straddle Tax Shelter), and Notice 2002-65, 2002-41 I.R.B. 690 (Passthrough Entity Straddle Tax Shelter), are substantially similar transactions. For purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if the gain and loss legs of the economically offsetting positions are triggered in separate taxable years, or a trust other than a grantor trust is used. Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2 and 301.6112-1).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this notice or substantially similar transactions and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction or substantially similar transactions and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions or, as applicable, on persons who participate in the reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662 and the return preparer penalty under § 6694.

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Volungis on (202) 622-3080 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 16, 2003
JS-570

MEDIA ADVISORY
President's Commission on United States Postal Service
Received Subcommittee Recommendations at Public Meeting

The President's Commission on the United States Postal Service today received and considered the recommendations of two of the four Commission subcommittees at its eighth public meeting in Washington, DC. The Commission will submit its report to the President by July 31, 2003.

The adopted recommendations are attached below.

The nine-member bipartisan Commission, established by President Bush on December 11, 2002, will identify the operational, structural, and financial challenges facing the Postal Service; examine potential solutions; and recommend legislative and administrative steps to ensure the long-term viability of postal services in the United States. The Commission is co-chaired by James A. Johnson, Vice Chairman of Perseus, L.L.C., and Harry J. Pearce, Chairman of Hughes Electronics Corporation.

Additional information about the Commission can be found at http://www.treasury.gov/offices/domestic-finance/usps

Related Documents:

- Recommendations Adopted by the Commission Report of the Business Model Subcommittee
- Recommendations Adopted by the Commission Report of the Private-Sector Parnership Subcommittee
- Recommendations Adopted by the Commission Report of the Co-Chairs

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 16, 2003
JS-571

**Statement of
Assistant Secretary for Financial Institutions Wayne A. Abernathy
Regarding Subcommittee Approval of FCRA Measure**

"Chairman Spencer Bachus, Congresswoman Darlene Hooley, and the cosponsors of the Fair and Accurate Credit Transactions Act of 2003, are to be congratulated for the approval of their bill today by the House Subcommittee on Financial Institutions and Consumer Credit.

The 41 to 0 vote demonstrates not only that they worked hard to get a lot of support, but that they produced a bill worthy of that support. This is a major piece of legislation, incorporating among its provisions in substance the elements of the Administration proposal announced by Secretary Snow on June 30. We look forward to continuing to work with the Congress as the bill moves on to consideration by the full Committee.

This prompt legislative action should serve to reassure consumers all across the country that vital action is being taken this year to improve the accuracy and security of their financial information-particularly in the fight against identity theft-while continuing to expand access to financial services for all Americans."

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 17, 2003
JS-572

Promoting Economic Growth in Brazil
Randal K. Quarles
Assistant Secretary of Treasury for International Affairs
Brazilian-American Chamber of Commerce, New York City
July 17, 2003

Thank you very much for inviting me here today. It's a pleasure to speak with you about Brazil, especially at a time of growing optimism about Brazil's future.

The name of this event—Brazil: From Stabilization to Growth—could not be more appropriate. Less than a year ago, the market was weighed down by uncertainty in the lead-up to an election that would provide Brazil new leadership after eight years of solid and stable policies under President Fernando Henrique Cardoso. This uncertainty, and a somewhat turbulent global environment at the time, combined to drive spreads on Brazilian bonds to more than 2400 basis points over U.S. Treasuries and the real to nearly four to the dollar. Since then, there has been rebound in market confidence and greater stability: the real has strengthened 20% and spreads on Brazilian bonds have narrowed to 800 basis points over U.S Treasuries.

This return of market confidence can be credited to the bold and far-sighted policy choices of the Lula Administration in its opening months in office. President Lula rightly recognized the importance of macroeconomic stability to the achievement of the social goals he articulated in his inauguration speech. As the government implements its program to forge a better life for all Brazilians, economic policies will continue to be integral to the achievement of this vision. The current period of rising confidence and stability creates a window of opportunity for looking beyond short-term financial concerns and focusing on the long-term priority of economic growth.

Today I would like to say a few words about developments in recent months, before turning to the opportunities that lie ahead.

The Start of the Lula Administration

President Lula and his economic team came into office committed to continued fiscal responsibility, and to a monetary policy that makes long-term price stability the top priority. They have delivered on their commitments: fiscal performance so far this year has exceeded formal targets established in Brazil's IMF program. And Brazil has formally committed to achieving similar primary surplus targets in 2004. Thanks to the Central Bank's continuing efforts to meet inflation targets, inflation is falling rapidly. Consumer prices declined in June for the first time in more than four years and inflation appears to be on the desired path.

Brazil's export sector has outperformed even the most optimistic expectations: June's trade surplus measured $2.4 billion, generating a record high trade surplus of $21 billion for the last 12 months. Even more compelling is the fact that these results have been achieved largely through export expansion rather than import compression. Brazil's impressive trade performance partially derives from expanding trade with non-traditional trading partners such as China. Diversifying its export markets not only increases total exports but also reduces vulnerabilities to volatility in any single market.

Finally, the Lula administration submitted to Brazil's Congress key pension and tax legislation that goes to the heart of Brazil's long-term fiscal position. Passage and implementation of these reforms will lay the foundation for the reduction of Brazil's debt levels and free up future government resources for productive investment. While more vigorous legislative debate lies ahead, we commend the government's efforts to build broad support for reforms while maintaining the key reform objectives.

Laying the Basis for Sustained Growth

In Brazil, as elsewhere, the ability of an economy to deliver rising standards of living depends upon increasing the amount of goods and services that each worker produces—or, in the language of economists, increasing productivity. Labor productivity in turn depends upon (1) the amount of capital that each worker has to work with, and (2) the technology and efficiency with which the factors of production are used. The goal of government policy should be to create an environment that increases productivity growth by encouraging investment (capital accumulation) and rewarding innovation, entrepreneurship and competition (technological progress and increased efficiency).

There is great potential for improving productivity growth in Brazil. Productivity declined dramatically during the crisis years of the 1980s. Market-oriented reforms in the 1990s were pivotal in reversing this trend. But productivity growth remains modest, and international experience suggests that more can be achieved.

Good economic policies can unleash Brazil's potential for substantial productivity gains. In Brazil, priority areas include tax and labor market policy, industrial regulation, the financial sector, health and education, and trade.

The Lula administration's proposed tax reform provides a good example of a reform to improve Brazil's business and investment environment and enhance the incentives for capital accumulation and economic activity. The proposal seeks to replace the remaining major cascading tax with a value-added tax. This would prevent double taxation on inputs and lower production costs—and that has an obvious positive impact on the competitiveness of Brazilian goods at home and abroad. Another key component of the legislation would reduce the payroll tax burden. High payroll taxes that keep labor costs high discourage job creation and push employment into the informal sector. Reduction of the payroll tax burden provides an incentive to bring Brazilian workers into the formal labor market.

The importance of incentives is also prominent in the area of regulatory policy. Attracting investment in Brazil's domestic infrastructure is essential to supporting activity throughout the economy. Clear and transparent regulation is needed to attract new investment to key industries such as energy and telecommunications, so that investors can be confident in the long-run viability of business plans. The United States knows from experience the complexities inherent in the regulation of key industries. We look forward to sharing our experiences with the Brazilian government as it continues its dialogue with investors, government entities, and consumers on regulatory reform.

Many observers have commented on the high cost of credit in Brazil as a constraint on investment. The government's continued progress in containing inflation will allow for further reductions in the benchmark Selic rate, which will have a direct impact on lowering borrowing costs. Beyond this, a number of factors contribute to high bank lending rates that make credit prohibitively expensive to most Brazilian businesses. Banks hold large amounts of Brazilian government debt, rather than loans, on the asset sides of their balance sheets. Continued progress with sound fiscal policies ought to allow a reduction in the total amount of government debt and thus a reduction in this "crowding out" of bank credit, thus increasing the availability of credit to the private sector. On the microeconomic side, high bank operating costs and weak creditor rights also keep borrowing costs high. Government policy matters here, too. Passage of bankruptcy legislation that has been pending in Brazil's Congress for nearly ten years would represent significant progress toward addressing the issue of creditor rights.

Experience from around the world has demonstrated that investing in people through health and education is needed to build a capable and industrious labor force. President Lula's Zero Hunger initiative is a good example of what the new administration is doing to provide for such basic needs. In education we hope that the Lula administration is successful in building on the progress of the 1990s that increased primary school enrollment and reduced the adult illiteracy rate. Passage of social security reform and other efforts to maintain sound public finances will free up government resources for additional investments in these areas.

Finally, the area of trade presents a tremendous growth opportunity for Brazil. The reduction of trade barriers encourages the growth of exports, enhances the competitiveness of domestic industry, and lowers the cost of goods to consumers. While Brazil has liberalized substantially in the last decade, total trade (exports plus imports) as a share of GDP remains relatively low by middle-income country standards at approximately 29% of GDP in 2002. By way of comparison, trade equals roughly half of Mexico's and Turkey's gross domestic products, two-thirds of Korea's GDP and more than 100% of Thailand's GDP in 2002. Brazil's trade performance over the past year, which resulted in an accumulated trade surplus through the first half of the year of $10 billion and a rolling 12-month surplus of $20 billion, demonstrates the importance of trade to the overall health of the Brazilian economy.

Important multilateral initiatives to reduce trade barriers—globally through the World Trade Organization, regionally through the Free Trade Area of the Americas (FTAA)—are now underway. Brazil is positioned to take a leadership role in these initiatives. Ambassador Zoellick was recently in Brazil to discuss next steps on the FTAA. While much work remains to be done, the United States remains committed to achieving the January 2005 deadline. As co-chairs of this effort, Brazil and the United States bear a significant responsibility for bringing the FTAA to fruition. Our goals are ambitious, but achievable.

U.S.-Brazilian Cooperation

The first months of the Lula administration provide a good indication of its seriousness in addressing Brazil's key economic challenges. Such a process is never easy. But for each obstacle, there is also an opportunity.

In this spirit, it was announced during President Lula's visit to Washington last month that the United States Treasury Department and Brazil's Finance Ministry will initiate regular consultations on accelerating economic growth in both countries. This dialogue—the Group for Growth—will facilitate in-depth discussions on growth strategies. It will enable us to share experience and best practices for addressing common challenges. It will provide a forum for discussions lessons learned in such areas as reforming fiscal and tax policies; reducing impediments to the creation and expansion of small and medium-sized companies; increasing investment and business credit; promoting trade; developing infrastructure; and strengthening domestic competition.

Through this and other areas of engagement, the United States looks forward to working with our Brazilian partners to advance growth and poverty reduction strategies in our two countries and throughout the hemisphere.

Thank you very much and I look forward to this morning's discussion.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 17, 2003
JS-573

Treasury Clarifies rules for Attribute Reduction after a Bankruptcy Reorganization

Today the Treasury Department and the IRS issued temporary regulations that clarify the rules for reducing tax attributes (e.g., net operating losses) for companies that undergo bankruptcy reorganizations. These regulations will prevent companies from taking the position that they are entitled to unreduced tax attributes after realizing discharge of indebtedness income in a year that ends with a bankruptcy reorganization. The temporary regulations apply to discharges of indebtedness occurring after July 17, 2003.

Related Documents:

- The text of the Temporary Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9080]

RIN 1545-BC47

Reduction of Tax Attributes Due to Discharge of Indebtedness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the reduction of tax attributes under sections 108 and 1017 of the Internal Revenue Code. These temporary regulations affect taxpayers that exclude discharge of indebtedness income from gross income under section 108. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These temporary regulations are effective **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**.

Applicability Date: These temporary regulations apply to discharges of indebtedness occurring after **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Theresa M. Kolish (202 622-7930) of the Office of the Associate Chief Counsel (Corporate) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The Debt Discharge Rules

Pursuant to section 61(a)(12), gross income includes income from the discharge of indebtedness (COD income). Section 108(a)(1), which reflects the amendments enacted in the Bankruptcy Tax Act of 1980, Public Law 96-589, section 2, 94 Stat. 3389 (1980) (1980-2 C.B. 607), however, provides that, where the discharge occurs in a title 11 case, where the taxpayer is insolvent, or where the indebtedness is "qualified farm indebtedness" or "qualified real property business indebtedness," gross income does not include any amount that otherwise would be includible in gross income by reason of that discharge (in whole or in part) of the indebtedness of the taxpayer.

Although section 108(a) excludes COD income from gross income under those circumstances, section 108(b) requires the reduction of certain tax attributes in an amount that reflects the amount excluded from gross income, thereby generally deferring, rather than permanently eliminating, the inclusion of COD income. Section 108(b)(2) requires the reduction of the following tax attributes of the taxpayer in the following order: (A) net operating losses; (B) general business credits; (C) minimum tax credits; (D) capital loss carryovers; (E) adjusted basis of property; (F) passive activity losses and credit carryovers; and (G) foreign tax credit carryovers. Section 108(b)(4)(A) provides that the reductions are made after the determination of the tax imposed for the taxable year of the discharge. Section 108(b)(4)(B) provides that the reductions of net operating losses and capital loss carryovers are made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose. If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is disregarded such that it does not result in income or have other tax consequences. See H.R. Rep. No. 96-833, at 11 (1980).

Instead of reducing tax attributes in the order set forth in section 108(b)(2), a taxpayer may elect under section 108(b)(5) to reduce first the adjusted bases of depreciable property to the extent of the excluded COD income. The amount to which the election applies is limited to the aggregate adjusted basis of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. If the adjusted bases of depreciable property are insufficient to offset the entire amount of excluded COD income, the taxpayer must then reduce any remaining tax attributes in the order set forth in section 108(b)(2). Congress intended the election under section 108(b)(5) to allow debtors, including debtors in bankruptcy, to account for a debt discharge amount in a manner most favorable to their tax situations. See S. Rep. No. 96-1035, at 10 (1980); H.R. Rep. No. 96-833, at 9 (1980).

Section 1017(a) provides that when any portion of COD income excluded from gross income under section 108(a) is to be applied to reduce basis, then such portion shall be applied to reduce the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. Section 1017(b)(1) provides that the amount of reduction under section 1017(a), and the particular properties the bases of which are to be reduced, shall be determined under regulations.

The Reorganization Rules

Section 368(a)(1) defines a reorganization to include certain types of asset acquisitions. Under section 361, a corporation that is a party to a reorganization recognizes neither gain nor loss when it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. If the corporation receives in the exchange not only stock or securities permitted to be received without the recognition of gain, but also other property or money, then the corporation may be required to recognize gain. Under section 362(b), if property is acquired by a corporation in connection with a reorganization, then the basis is the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer.

Section 332(a) provides that a corporation recognizes no gain or loss on the receipt of property distributed in complete liquidation of another corporation. Section 337(a) provides that a liquidating corporation recognizes no gain or loss on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies. Under section 334(b)(1), if property is received by a corporate distributee in a distribution in a complete liquidation to which section 332 applies, the basis of such property in the hands of such distributee is the same as it would be in the hands of the transferor. However, in any case in which gain or loss is recognized by the liquidating corporation with respect to such property, the basis of such property in the hands of such distributee is the fair market value of the property at the time of the distribution.

Section 381 provides that a corporation that acquires the assets of another corporation in a distribution to which section 332 applies or in a transfer to which section 361 applies (but only if the transfer is in connection with certain reorganizations described in sections 368(a)(1)(A), (C), (D), (F), or (G)) shall succeed to, and take into account, as of the close of the day of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation, subject to certain conditions and limitations. Among those items described in section 381(c) are net operating loss carryovers, capital loss carryovers, general business credits, and minimum tax credits. With respect to net operating loss carryovers and capital loss carryovers, the regulations under section 381 reflect that the acquiring corporation succeeds to only those carryovers that remain after the application of sections 172 and 1212 and their carryforward and carryback provisions. See §§1.381(c)(1)-1; 1.381(c)(3)-1. Furthermore, those regulations provide that the acquiring corporation succeeds to only those general business credits that remain unused by the transferor corporation after computing its taxable income for the year of the transfer. See §1.381(c)(23)-1. Section 381(b)(1) provides that, except in the case of an acquisition in connection with a reorganization described in section 368(a)(1)(F), the taxable year of the distributor or transferor corporation ends on the date of distribution or transfer.

Interaction Between Debt Discharge and Reorganization Rules

Questions have arisen regarding the application of the attribute reduction rules of sections 108 and 1017 when a transaction described in section 381(a) ends a taxable year in which the transferor excludes COD income from gross income. If section 108(b)(4)(A) and section 1017 were interpreted to require attribute reduction to occur after the close of the taxable year of discharge and after the transfer of assets and carryover of items described in section 381(c), then arguably no attributes described in section 108(b)(2) would be available for reduction.

Explanation of Provisions

The IRS and Treasury Department believe that the rule of section 108(b)(4)(A) prescribes an ordering of calculations. First, section 108(b)(4)(A) requires a determination of the taxpayer's tax for the taxable year of discharge in order to identify the amounts, if any, of the tax attributes described in section 108(b)(2) that remain available for reduction. Second, section 108(b)(4)(A) requires the reduction of those attributes. This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.

Similarly, the IRS and Treasury believe that the rule of section 1017 prescribes an ordering of calculations. The Bankruptcy Tax Act of 1980 reflects that Congress enacted the rule of section 1017 "to avoid interaction between basis reduction and reduction of other attributes." S. Rep. No. 96-1035, at 14 (1980); H. Rep. No. 96-833, at 11 (1980). Without this rule, a circular calculation could be required. The taxpayer's net operating loss for the year of the discharge of indebtedness might be based in part on the amount of cost recovery deductions allowed to the taxpayer. The amount of cost recovery deductions, however, would depend on the taxpayer's basis in its depreciable or amortizable property at the end of the year. Because net operating losses are reduced by excluded COD income prior to the reduction of asset basis absent an election under section 108(b)(5), the amount of basis required to be reduced would depend on the amount of net operating losses. Reducing the basis of property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs avoids this circularity.

The position that sections 108 and 1017 require the reduction of attributes, including the basis of transferred assets, in cases where the debtor's taxable year ends with a transfer of assets in a transaction described in section 381 is consistent with the policies underlying sections 108 and 1017 and the corporate reorganization provisions, including "deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge." S.

Rep. No. 96-1035, at 10 (1980). For example, assume that a debt of corporation X is discharged in a title 11 case. X's attributes described in section 108(b)(2) consist solely of basis in property. As part of a plan of reorganization, X transfers all of its assets to a newly formed corporation, Y. Under section 368(a)(3)(C), even though the transaction also qualifies as a reorganization under section 368(a)(1)(F), the transaction is treated as qualifying as a reorganization only under section 368(a)(1)(G). If sections 108 and 1017 were interpreted to not require a reduction of the bases of the property transferred, X would permanently exclude from gross income the COD income, notwithstanding that X underwent nothing more than a mere change in identity, form, or place of organization. Accordingly, consistent with the legislative history of the Bankruptcy Tax Act of 1980, the IRS and Treasury Department believe that the basis reduction rules of sections 108 and 1017 apply to property of a debtor transferred in a transaction described in section 381(a).

The legislative history of the Bankruptcy Tax Act of 1980 reflects that Congress specifically anticipated that amounts that carry over in a transaction described in section 381, including the basis of transferred property, are to be adjusted under the rules of sections 108 and 1017 to account for excluded COD income. See H.R. Rep. No. 96-833, at 32-34 (1980). The legislative history states:

> Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100,000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.
>
> Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

> The transaction would qualify as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A would recognize no gain or loss on the transfer of its assets to B (sec. 361). B's basis in the assets would be $75,000 (sec. 362), and B would succeed to A's net operating loss carryover (sec. 381).
>
> Under the bill, . . . [o]n the distribution of B stock to A's trade creditors, A excludes from gross income the debt discharge amount of $50,000 -- i.e., the difference between the $100,000 debt held by non-security creditors and the $50,000 worth of stock given for such debt. A may elect to reduce the basis of its depreciable assets transferred to B by all or part of the $50,000 debt discharge amount; to the extent the election is not made, the debt discharge amount reduces A's net operating loss carryover by the remainder of the debt discharge amount.

H.R. Rep. No. 96-833, at 34 (1980). The treatment of the net operating loss and basis in the legislative history demonstrates that, in a transaction described in section 381, the transferor's attributes, including the basis of transferred property, that carry over to the transferee are reduced.

Accordingly, these temporary regulations clarify that, in the case of a transaction described in section 381(a) that ends a year in which the distributor or transferor corporation excludes COD income from gross income under section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by sections 108 and 1017. For this purpose, all attributes listed in section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), including the basis of property, but after the determination of tax for the year of the discharge, are available for reduction under section 108(b)(2).

These temporary regulations also clarify that the tax attributes subject to reduction under section 108(b)(2) that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are first taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2).

These temporary regulations apply to discharges of indebtedness occurring after [**INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER**].

Special Analyses

It has been determined that these temporary regulations are 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 Procedures Act (5 U.S.C. chapter 5) does not apply to these temporary regulations, and, because no preceding notice of proposed rulemaking is required for these temporary regulations, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Theresa M. Kolish, Office of Associate Chief Counsel (Corporate). 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.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Section 1.108-7T also issued under 26 U.S.C. 108. * * *

Par. 2. Section 1.108-7T is added to read as follows:

§1.108-7T Reduction of attributes (temporary).

(a) In general. (1) If a taxpayer excludes discharge of indebtedness income (COD income) from gross income under section 108(a)(1)(A), (B), or (C), then the amount excluded shall be applied to reduce the following tax attributes of the taxpayer in the following order:

(i) Net operating losses.

(ii) General business credits.

(iii) Minimum tax credits.

(iv) Capital loss carryovers.

(v) Basis of property.

(vi) Passive activity loss and credit carryovers.

(vii) Foreign tax credit carryovers.

(2) The taxpayer may elect under section 108(b)(5), however, to reduce first the basis of depreciable property to the extent of the excluded COD income. If the basis of depreciable property is insufficient to offset the entire amount of the excluded COD income, the taxpayer must then reduce any remaining tax attributes in the order specified in section 108(b)(2). If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income. For rules relating to basis reductions required by

sections 108(b)(2)(E) and 108(b)(5), see section 1017 and §1.1017-1. For rules relating to the time and manner for making an election under section 108(b)(5), see §1.108-4.

(b) Carryovers and carrybacks. The tax attributes subject to reduction under section 108(b)(2) and paragraph (a)(1) of this section that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2) and paragraph (a)(1) of this section.

(c) Transactions to which section 381 applies. In the case of a transaction described in section 381(a) that ends a taxable year in which the distributor or transferor corporation excludes COD income under section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by section 108(b). For this purpose, all attributes listed in section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the discharge, including basis of property, shall be available for reduction under section 108(b)(2).

(d) Examples. The following examples illustrate the application of this section:

Example 1. (i) Facts. In Year 4, X, a corporation in a title 11 case, is entitled under section 108(a)(1)(A) to exclude from gross income $100,000 of COD income. For Year 4, X has gross income in the amount of $50,000. In each of Years 1 and 2, X had no taxable income or loss. In Year 3, X had a net operating loss of $100,000, the use of which when carried over to Year 4 is not subject to any restrictions other than those of section 172.

(ii) Analysis. Pursuant to paragraph (b) of this section, X takes into account the net operating loss carryover from Year 3 in computing its taxable income for Year 4 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss carryover that is reduced under section

108(b)(2) and paragraph (a) of this section is $50,000.

Example 2. (i) Facts. The facts are the same as in Example 1, except that in Year 4 X sustains a net operating loss in the amount of $100,000. In addition, in each of Years 2 and 3, X reported taxable income in the amount of $25,000.

(ii) Analysis. Pursuant to paragraph (b) of this section and section 172, the net operating loss sustained in Year 4 is carried back to Years 2 and 3 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss that is reduced under section 108(b)(2) and paragraph (a) of this section is $50,000.

Example 3. (i) Facts. In Year 2, X, a corporation in a title 11 case, has outstanding trade debts of $200,000 and a depreciable asset that has an adjusted basis of $75,000 and a fair market value of $100,000. X has no other assets or liabilities. X has a net operating loss of $80,000 that is carried over to Year 2 but has no general business credit, minimum tax credit, or capital loss carryovers. Under a plan of reorganization, X transfers its asset to Corporation Y in exchange for Y stock with a value of $100,000. X distributes the Y stock to its trade creditors in exchange for release of their claims against X. X's shareholders receive nothing in the transaction. The transaction qualifies as a reorganization under section 368(a)(1)(G) that satisfies the requirements of section 354(a)(1)(A) and (B). For Year 2, X has gross income of $10,000 (without regard to any income from the discharge of indebtedness) and is allowed a depreciation deduction of $10,000 in respect of the asset. In addition, it generates no general business credits.

(ii) Analysis. On the distribution of Y stock to X's trade creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of $100,000. (Under section 108(e)(8), X is treated as satisfying $100,000 of the debt owed the trade creditors for $100,000, the fair market value of the Y stock transferred to those creditors.) In Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by $10,000 to $65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). Pursuant to paragraph (a) of this section, X's net operating loss carryover in the amount of $80,000 is reduced by $80,000 of the COD income excluded under section 108(a)(1). In addition, X's basis in the asset is reduced by $20,000, the extent to which the COD income excluded under section 108(a)(1) did not reduce the net operating loss. Accordingly, as a result of the reorganization, there is no net operating loss to which Y succeeds under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is $45,000.

Example 4. (i) Facts. The facts are the same as in Example 3, except that X elects under section 108(b)(5) to reduce first the basis of its depreciable asset.

(ii) Analysis. As in Example 3, on the distribution of Y stock to X's trade creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of $100,000. In addition, in Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by $10,000 to $65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). As a result of the election under section 108(b)(5), X's basis in the asset is reduced by $65,000 to $0. In addition, X's net operating loss is reduced by $35,000, the extent to which the amount excluded from income under section 108(a)(1)(A) does not reduce X's asset basis. Accordingly, as a result of the reorganization, Y succeeds to X's net operating loss in the amount of $45,000 under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is $0.

(e) Effective date. This section applies to discharges of indebtedness occurring after **[INSERT DATE THESE REGULATIONS ARE FILED WITH THE FEDERAL REGISTER]**.

Par. 3. Section 1.1017-1 is amended by adding paragraph (b)(4) to read as follows:

§1.1017-1 Basis reductions following a discharge of indebtedness.

* * * * *

(b) * * *

(4) For further guidance, see §1.1017-1T(b)(4).

* * * * *

Par. 4. Section 1.1017-1T is added to read as follows:

§1.1017-1T Basis reductions following a discharge of indebtedness (temporary).

(a) through (b)(3) [Reserved]. For further guidance, see §1.1017-1(a) through (b)(3).

(4) Transactions to which section 381 applies. In the case of a transaction described in section 381(a) that ends a taxable year in which the distributor or transferor corporation excludes COD income from gross income under section 108(a), the basis of property acquired by the

acquiring corporation in the transaction shall reflect the reductions required by section 1017 and this section. For this purpose, the basis of property of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the discharge, shall be available for reduction under section 108(b)(2). See §1.108-7T. This paragraph (b)(4) applies to discharges of indebtedness occurring after **[INSERT DATE THESE REGULATIONS ARE FILED WITH THE FEDERAL REGISTER]**.

(c) through (i) [Reserved]. For further guidance, see §1.1017-1(c) through (i).

Deputy Commissioner for Services and Enforcement.

Approved:

Assistant Secretary of the Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 17, 2003
JS-574

Treasury Announces Opening of Second Round of Competition$3.5 Billion to be Invested in Low-Income Communities

The Treasury Department today announced the second competitive round for the allocation of tax credits for up to $3.5 billion in qualified equity investments under the New Markets Tax Credit (NMTC) Program. This represents the combined allocations for 2003 and 2004.

"Awards under the NMTC Program support the President's agenda for economic growth and job creation," said Treasury Secretary John W. Snow. "The NMTC Program has the potential to stimulate private sector investment in the nation's low-income communities across our nation, creating needed jobs and opportunities for many Americans who might not otherwise have them. It also does so in a way that holds participants accountable for producing results."

Created by Congress in December 2000, the NMTC Program permits individual and corporate taxpayers to receive a credit against Federal income taxes for making Qualified Equity Investments in investment vehicles known as Community Development Entities, or CDEs. Substantially all of the investment must in turn be used by CDEs to make qualified investments in low-income communities. The credit provided to the taxpayer totals 39 percent of the cost of the investment and is claimed over a seven-year credit allowance period.

Guidance on the second round of allocations will be available with the publication of the Notice of Allocation Availability in the Federal Register on July, 18, 2003. Successful CDEs will be allocated NMTCs after a competitive application and review process, which is administered by Treasury's Community Development Financial Institutions (CDFI) Fund. The allocation application deadline is September 30, 2003.

"The NMTC Program has the potential to make a significant impact in low income communities," said Tony T. Brown, Director of the CDFI Fund. "It offers a tremendous opportunity to focus capital investment on these communities, capital which will result in the creation of jobs and new economic activity."

For more information please visit the CDFI Fund's web site at: www.cdfifund.gov .

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.
July 17, 2003

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $32,000 million to refund an estimated $29,127 million of publicly held 13-week and 26-week Treasury bills maturing July 24, 2003, and to raise new cash of approximately $2,873 million. Also maturing is an estimated $12,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced July 21, 2003.

The Federal Reserve System holds $13,592 million of the Treasury bills maturing on July 24, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held July 22, 2003. Amounts awarded to SOMA will be in addition to the offering amount.

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

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $1,069 million into the 13-week bill and $640 million into the 26-week bill.

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

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

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

oOo

Attachment

JS-575

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED JULY 24, 2003

July 17, 2003

Offering Amount	$15,000 million	$17,000 million
Maximum Award (35% of Offering Amount)	$ 5,250 million	$ 5,950 million
Maximum Recognized Bid at a Single Rate	$ 5,250 million	$ 5,950 million
NLP Reporting Threshold	$ 5,250 million	$ 5,950 million
NLP Exclusion Amount	$ 5,600 million	None

Description of Offering:

Term and type of security	91-day bill	182-day bill
CUSIP number	912795 NT 4	912795 PG 0
Auction date	July 21, 2003	July 21, 2003
Issue date	July 24, 2003	July 24, 2003
Maturity date	October 23, 2003	January 22, 2004
Original issue date	April 24, 2003	July 24, 2003
Currently outstanding	$22,073 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

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

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

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.

(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.

(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

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

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

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 18, 2003
JS-576

Statement by Treasury Secretary John Snow
at the conclusion of visits to the United Kingdom and Germany
Amerika Haus, Frankfurt, Germany
July 18, 2003

Achieving strong and vibrant global growth is one of the world's most pressing priorities. We live in an interdependent world economy where our fortunes are inextricably linked. My visits this week have served to confirm my view that economic cooperation between the United States and Europe is vital for improving living standards - not just in our regions, but also in the emerging and developing economies as well. The European economy depends on the United States. The U.S. economy depends on Europe. And the global economy is counting on our leadership.

This week I visited London - Europe's primary financial center, and Germany - Europe's largest economy to learn about European economic prospects and what we in the United States can do to help promote strengthened growth in Europe and throughout the globe.

The United States has been doing its part to spur economic growth. The combined impact of accommodative monetary policy, President Bush's Jobs and Growth package, low inflation, low interest rates, and necessary adjustments by U.S. businesses cause me to believe that the United States is poised for stronger growth.

Over the past 30 months the U.S. economy has proven to be remarkably resilient and flexible - weathering the storms of a recession, terrorist attacks, upheaval in the corporate world, and the winding down of the "millennium bubble." While our economic recovery to date has not been as strong as we would like, growth reached 2.9% in 2002, despite a very weak first half of the year.

This year I expect growth to exceed 3% in the third and fourth quarters of this year, and 4% next year - expectations echoed by private Blue Chip forcasts.

The fiscal deficit in the United States will be larger this year. While this is to be expected, no one is happy about increased deficits. But our deficit level is manageable and I expect a growing economy combined with spending restraint will put U.S. fiscal deficits on a declining path.

The United States is returning to growth, but the world economy needs multiple engines of growth. I am encouraged that important developments underway in Europe can help this market return to growth as well. Restoring economic growth requires more than sound macroeconomic policy; it also requires appropriate structural reforms that promote strong domestic demand led growth.

Here in Germany, Chancellor Schröeder and Finance Minister Eichel have put together a three-part strategy to support growth and achieve vitally needed structural reforms. This strategy focuses on the Agenda 2010 labor market, health and pension reforms, budget consolidation and tax reform. While the returns from these reforms may not be immediately evident, these efforts are vital for Germany to restore vibrant long-term growth. Importantly, in all of my conversations this week I learned that public opinion is supportive of reforms and that the German people recognize the need for change. This is very positive and I applaud and encourage continued attention to these reforms.

In the United Kingdom I met with Gordon Brown, Chancellor of the Exchequer, and Mervyn King, Governor of the Bank of England. Prime Minister Blair and his economic team are implementing sound policies and continue to make reforms to keep their nation competitive and growing. They never fail to inspire thoughtful analysis and creative solutions to our shared economic challenges.

While I did not visit France on this trip, I should also note that I am pleased with developments inthat country as well. President Chirac and Finance Minister Mer are moving ahead with important tax and pension reforms, which should help to improve France's ability to become more productive and contribute to growth. I took note that President Chirac also raised the question of how the Stability and Growth Pact can contribute to growth.

Yesterday, I met with Otmar Issing at the European Central Bank, and this morning with Jean Claude Trichet, the incoming President of ECB. They each discussed with me ECB's commitment to price stability and prospects for growth in the Euro area for this year and next.

Throughout this trip I was very pleased to discuss a number of trans-Atlantic issues - issues that rarely earn headlines, but nonetheless, are being resolved in a spirit of cooperation that will greatly benefit our economies. Both in London and Frankfurt we had detailed discussions capital market issues, regulation of accounting practices and financial services, and importantly, the contributions that strengthened corporate governance can make to improving investor sentiment. We also discussed the significant impact that Europe's efforts to create an integrated financial system would make to European growth.

My colleagues and I also agreed on the need to work together to ensure a successful Doha trade round. The world is awaiting our leadership so that all nations can share in the benefits of free and open trade.

As I conclude this visit I am reinforced in my belief that the global economy depends on Europe and the United States working in partnership to clear away inefficiencies and put in place policies that will lead to robust growth. And I come away encouraged that Europe is committed to taking steps that will lead to stronger growth in the future.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 18, 2003
JS-577

Treasury and IRS Issue Temporary and Proposed Regulations on S Corporation ESOPS

Today, the Treasury Department and the IRS issued temporary and proposed regulations to shut down abusive arrangements involving certain employee stock ownership plans (ESOPs) holding stock in S corporations. The regulations, issued under section 409(p), will go into effect in 90 days for certain S corporation ESOPs.

Congress enacted section 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 to prevent the owners of an S corporation from using an ESOP to shelter business income from tax. Stockholders in an S corporation normally pay tax currently on the S corporation's income, but an ESOP is exempt from tax. Section 409(p) requires that an ESOP owning stock in an S corporation must provide meaningful benefits to a broad group of rank-and-file employees of the S corporation.

Treasury and the IRS have become aware of arrangements marketed to avoid section 409(p). These arrangements include giving former owners of the S corporation deferred compensation from a management company related to the S corporation or special rights to acquire assets of the S corporation. The new regulations make clear that the deferred compensation and the special rights will be treated as "synthetic equity" - typically resulting in both income and excise taxes to the former owners of the S corporation.

Assistant Secretary for Tax Policy Pamela Olson said, "With section 409 (p), Congress made clear that S corporation ESOPs should be used for rank-and-file employees to benefit from company ownership, and not as a tax shelter for a small group of former owners and executives. These regulations are a first step in targeting arrangements that abuse the S corporation ESOP rules. They are not the final step - we expect to continue to work with the ESOP community to develop guidance addressing other arrangements that attempt to skirt the rules."

The temporary regulations are effective in 2005 for S corporation ESOPs that were in existence on March 14, 2001. For other S corporation ESOPs, these regulations are effective for taxable years ending after the date that is 90 days after publication of the regulations.

Related Documents:

- Temporary Regs
- Proposed Regs

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 18, 2003
JS-578

Statement by Treasury Secretary Snow on Strengthening America's Pension System

Today's action on the Portman-Cardin pension bill by the House Committee on Ways and Means begins the process intended to strengthen the retirement security of working and retired Americans with traditional pension plans.

We will continue to work with Congress to achieve the President's goal of accurate pension funding rules, and to ensure that pension promises made are pension promises kept.

As we work towards a more comprehensive reform of the pension system, the President continues to believe that these changes must include a more accurate measure of pension liabilities, increased transparency of pension plan information, and safeguards against pension under-funding.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 18, 2003
JS-579

Statement by Treasury Spokesman Rob Nichols
Secretary Snow to Travel to Wall Street

Treasury Secretary John Snow will travel to New York on Tuesday, July 22nd to promote President Bush's economic agenda. During meetings on Wall Street with investors, fund managers and economists, Secretary Snow will discuss the state of the U.S. economy, global growth prospects, and the Administration's efforts to strengthen the economic recovery and create jobs.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 21, 2003
2003-7-21-11-34-36-23117

Media Advisory
President's Commission on United States Postal Service Holds Final Public Meeting July 23 in Washington, DC

The President's Commission on the United States Postal Service will hold its ninth and final public meeting on July 23, 2003 in Washington, DC.

At the meeting, the Commission will receive and consider the recommendations of its Workforce subcommittee and Technology Challenges and Opportunities subcommittee. The Commission also will consider a draft final report to the President. Under Executive Order 13278, the Commission's final report must be transmitted to the President on or before July 31, 2003.

The meeting will take place at 9:00 am EDT at the Ronald Reagan Building and International Trade Center, Polaris Suite (Concourse Level C), 1300 Pennsylvania Ave., NW, Washington, DC. It is open to the public and the media, and the Commission co-chairmen will be available for questions from the media after the meeting concludes.

The nine-member bipartisan Commission, established by President Bush on December 11, 2002, will identify the operational, structural, and financial challenges facing the Postal Service; examine potential solutions; and recommend legislative and administrative steps to ensure the long-term viability of postal services in the United States. The Commission is co-chaired by James A. Johnson, Vice Chairman of Perseus, L.L.C., and Harry J. Pearce, Chairman of Hughes Electronics Corporation.

Additional information about the Commission can be found at:
www.treasury.gov/offices/domestic-finance/usps

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 28, 2003
JS-580

Treasury Announces Market Financing Estimates

The Treasury Department announced today that it expects to borrow $104 billion in marketable debt during the July – September 2003 quarter and to target a cash balance of $45 billion on September 30. In the last quarterly announcement on April 28, 2003, Treasury announced that it expected to borrow $76 billion in marketable debt and to target an end-of-quarter cash balance of $45 billion on September 30. This increase is due to somewhat lower receipts and higher outlays. Higher marketable borrowing will be partially offset by a reduction in compensating balances following the introduction of Depositary Compensation Securities (announced on July 3, 2003) and higher non-marketable borrowing through higher net issues of State and Local Series securities.

Treasury also announced that it expects to borrow $126 billion in marketable debt during the October – December 2003 quarter and to target a cash balance of $45 billion on December 31.

During the April – June 2003 quarter, Treasury borrowed $60 billion in marketable debt and ended with a cash balance of $30 billion on June 30. On April 28, Treasury announced that it expected to borrow $79 billion in marketable debt and to target an end-of-quarter cash balance of $45 billion. The lower end-of-quarter cash balance reflects reduced borrowing from Treasury's earlier projection.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, July 30.

Related Documents:

- August 2003 Charts

TREASURY FINANCING REQUIREMENTS

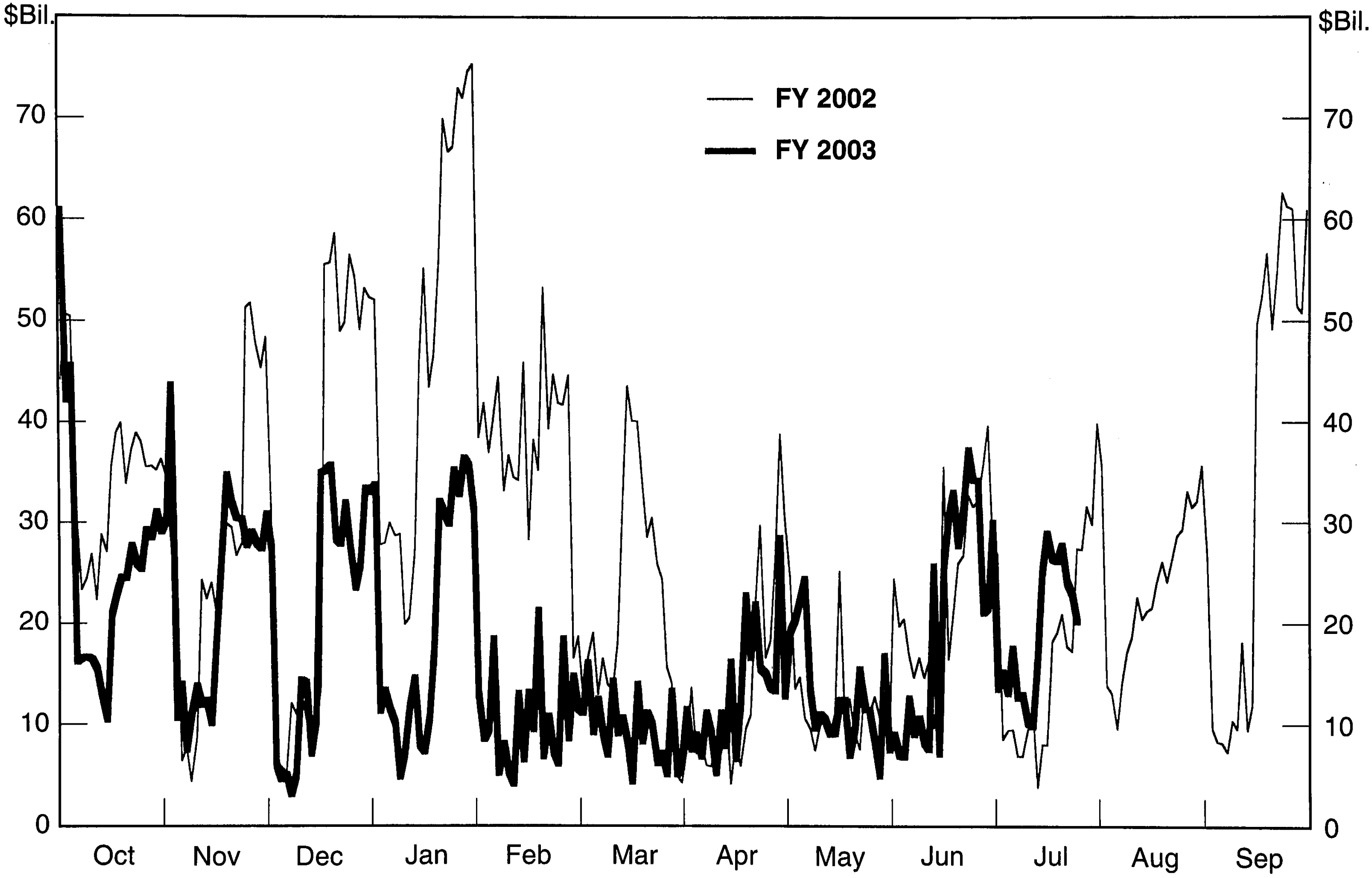
$ Billions

	April - June 2003 (Projected)	April - June 2003 (Actuals)	July - Sept. 2003 (Projected)
Deficit Funding (Def + / Surplus -) *	**17**	**18**	**138**
Means of Financing			
Change in Cash Balance	-32	-17	-15
Compensating Balances	-18	-12	28
Net Non-Marketable Financing	-5	-9	16
Net Marketable Financing	79	60	104
Other	-6	-4	5
Net Marketable Financing	**79**	**60**	**104**
Bills		-27	
Nominal Notes		91	
IIS		0	
Bonds (20-yr)		-3	
Notes:			
Starting Cash Balance	13	13	30
Ending Cash Balance	45	30	45

* Includes budget results, direct loan activity, changes in accrued interest and checks outstanding and minor miscellaneous transactions.

Note: Totals may not add due to rounding

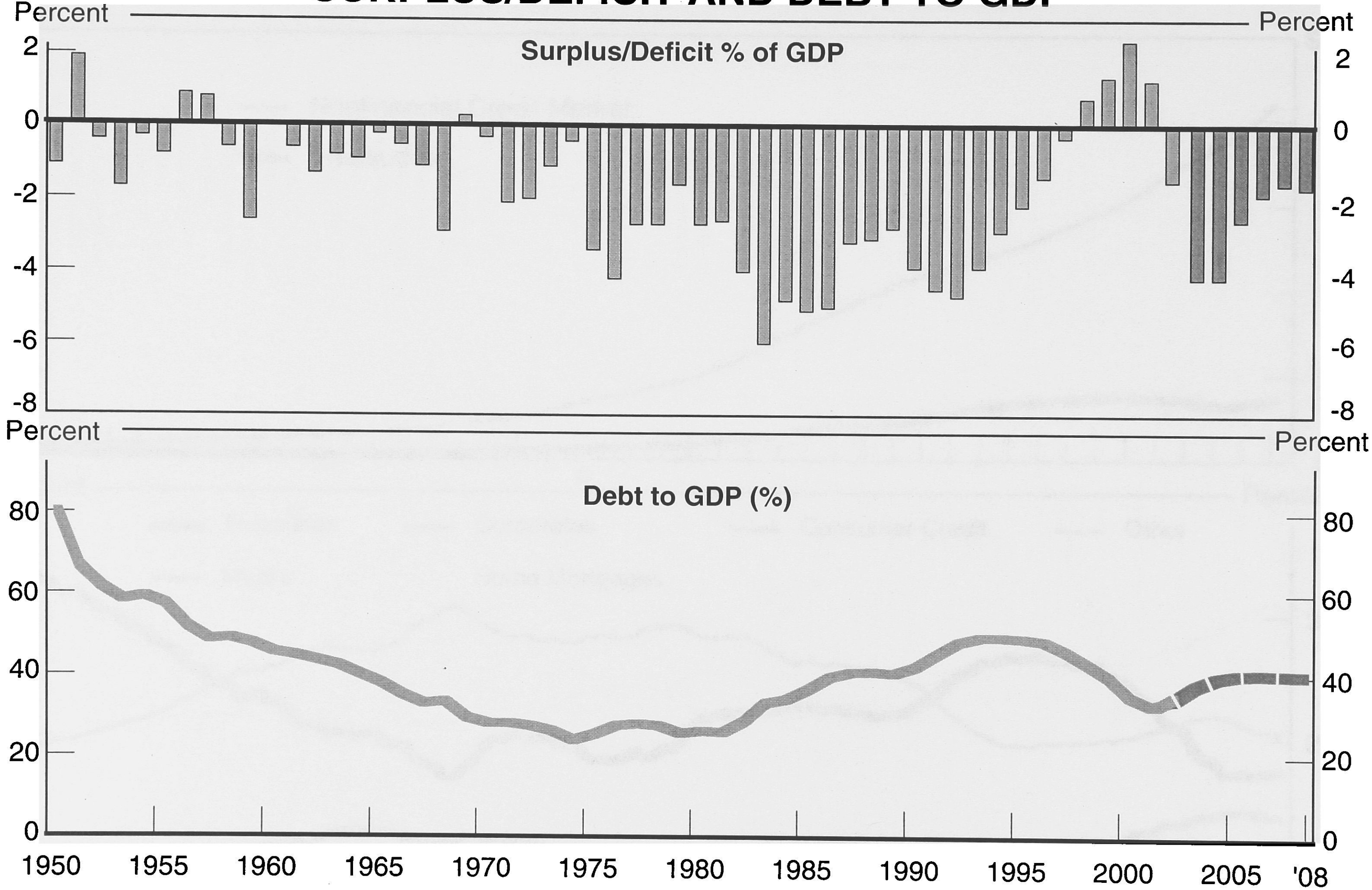
TREASURY DAILY OPERATING CASH BALANCE



Source: Daily Treasury Statement, data through July 24, 2003.

Department of the Treasury
Office of Market Finance

SURPLUS/DEFICIT AND DEBT TO GDP [1/]



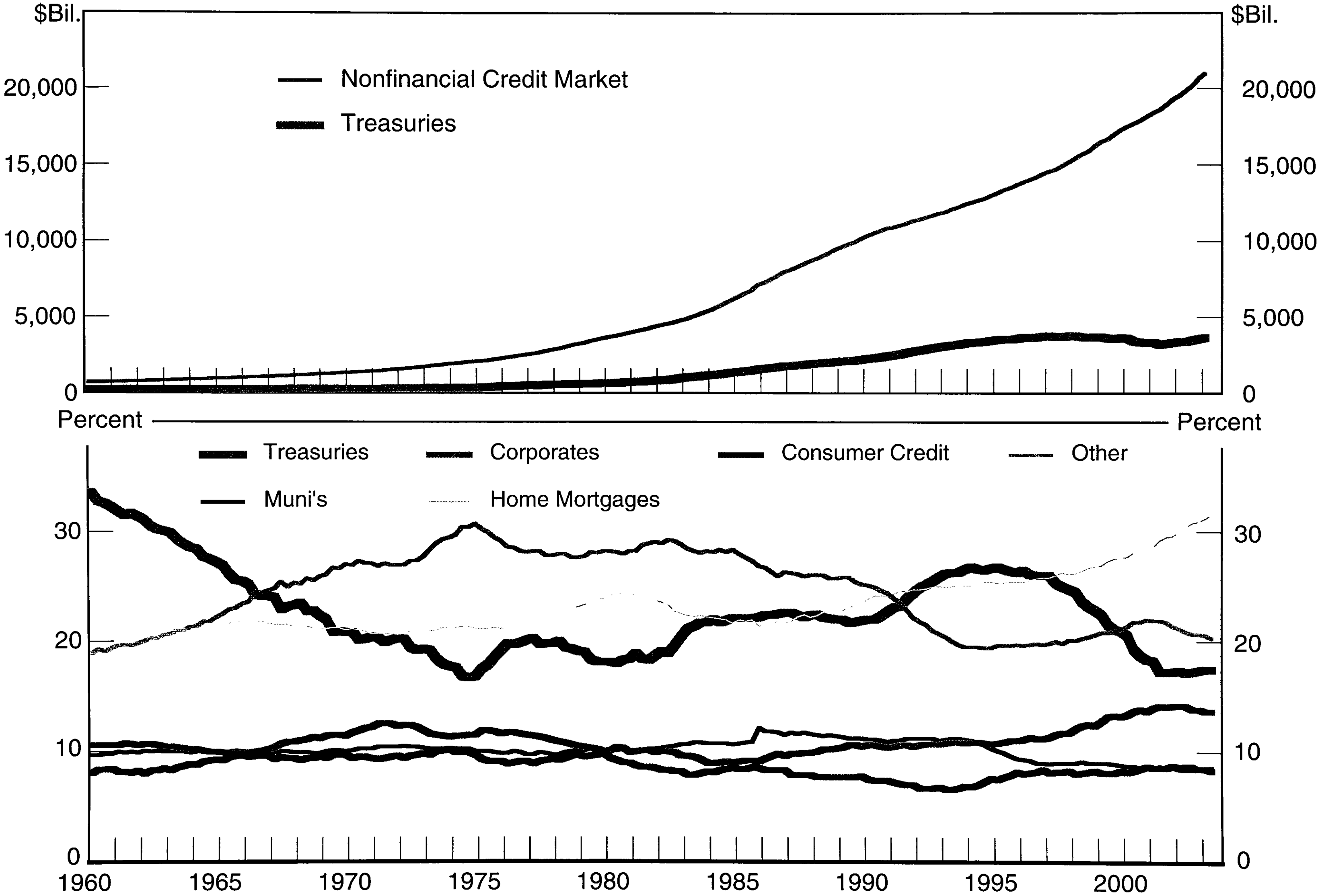
1/ FY 2003-08 estimates from OMB Budget of the United States Government FY 2004 Mid-Session Review.

Source: Budget Historical Tables 1.2 & 7.1.

Department of the Treasury
Office of Market Finance

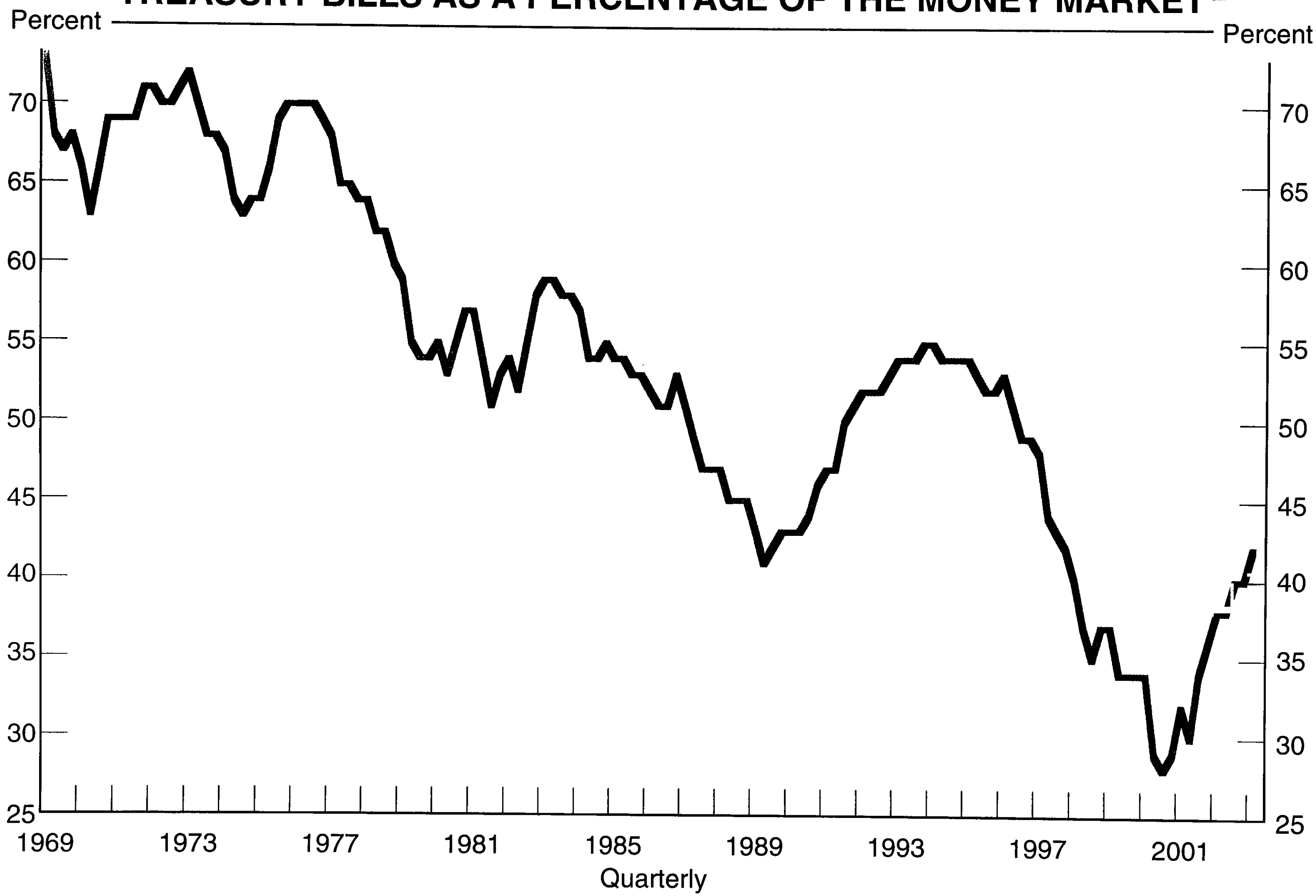
July 28, 2003-3

DOMESTIC NONFINANCIAL CREDIT MARKET AND TREASURY DEBT



Source: U.S. Federal Reserve Board of Governors Flow of Funds.

TREASURY BILLS AS A PERCENTAGE OF THE MONEY MARKET [1/]

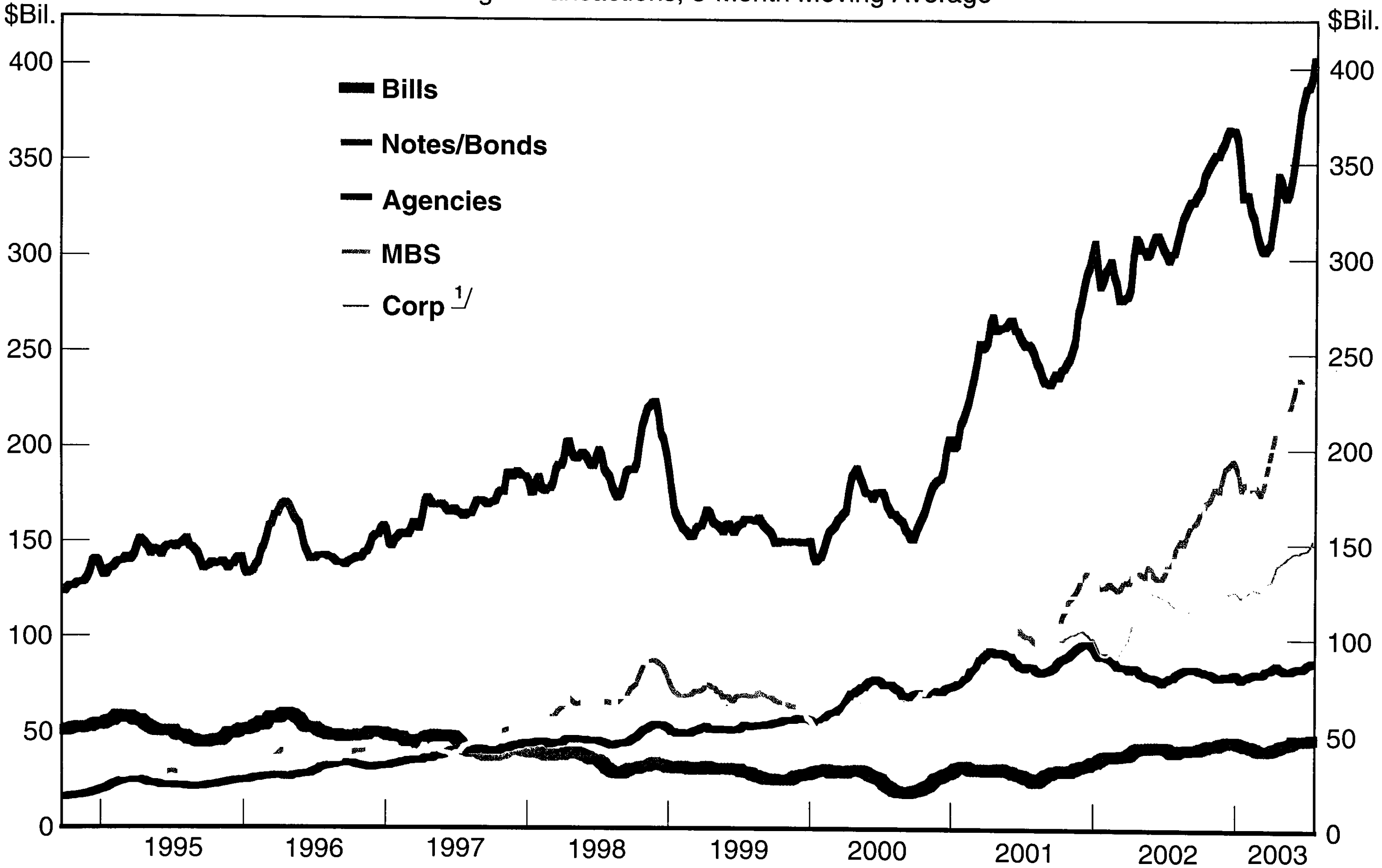


[1/] Money market = Treasury bills, nonfinancial commercial paper, and financial open market paper.

Source: U.S. Federal Reserve Board of Governors Flow of Funds statistical release Z.1.

PRIMARY DEALER TRADING VOLUME

Outright Transactions, 3-Month Moving Average



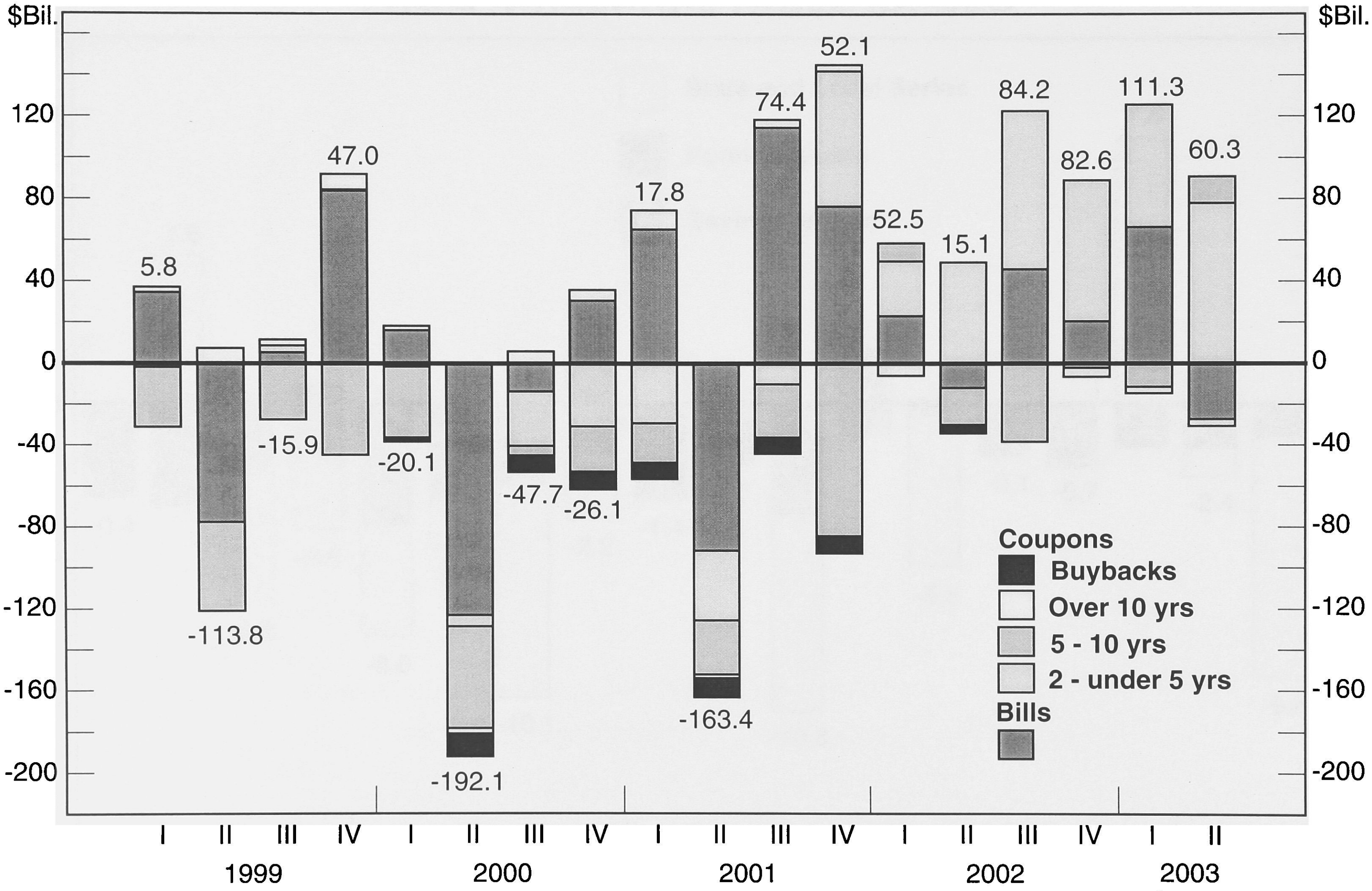
1/ Data available beginning September 26, 2001

Source: Federal Reserve Bank of New York.

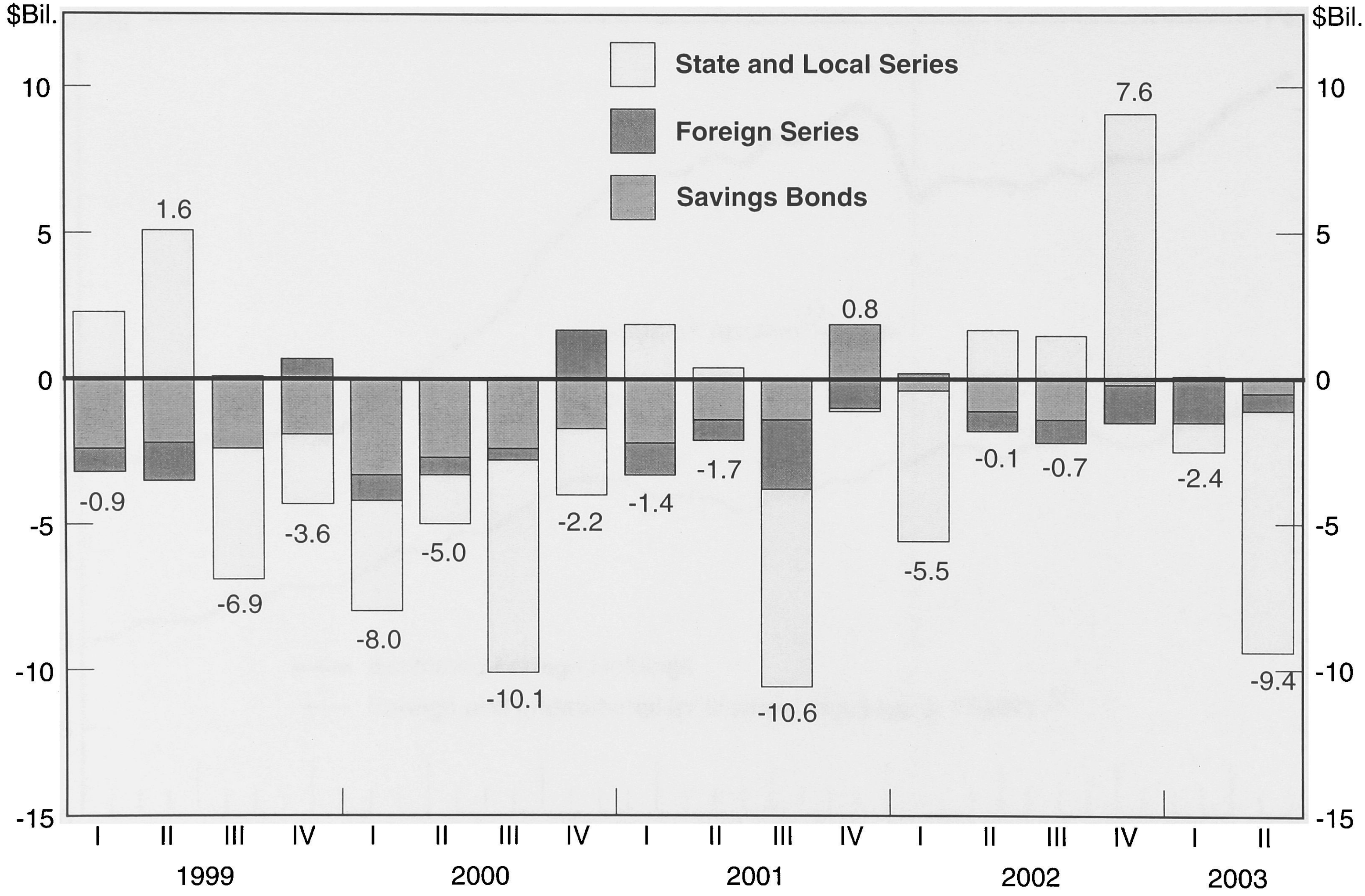
Department of the Treasury
Office of Market Finance

July 28, 2003-6

TREASURY QUARTERLY NET MARKET BORROWING



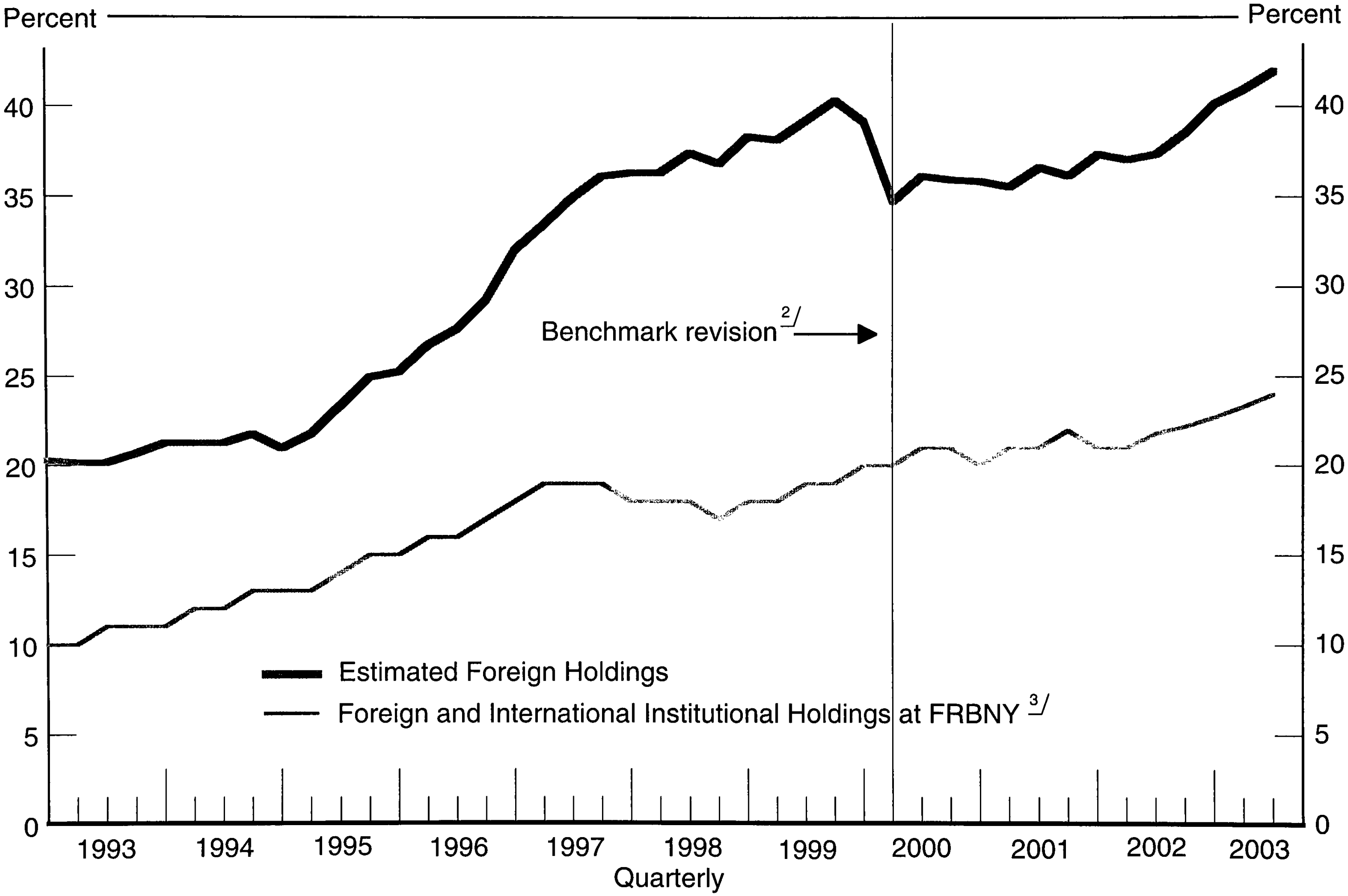
TREASURY QUARTERLY NET BORROWING FROM NONMARKETABLE ISSUES



Note: Treasury suspended new issuance of State and Local Government Series (SLGS) Treasury securities from May 15, 2002—July 8, 2002.

Department of the Treasury
Office of Market Finance

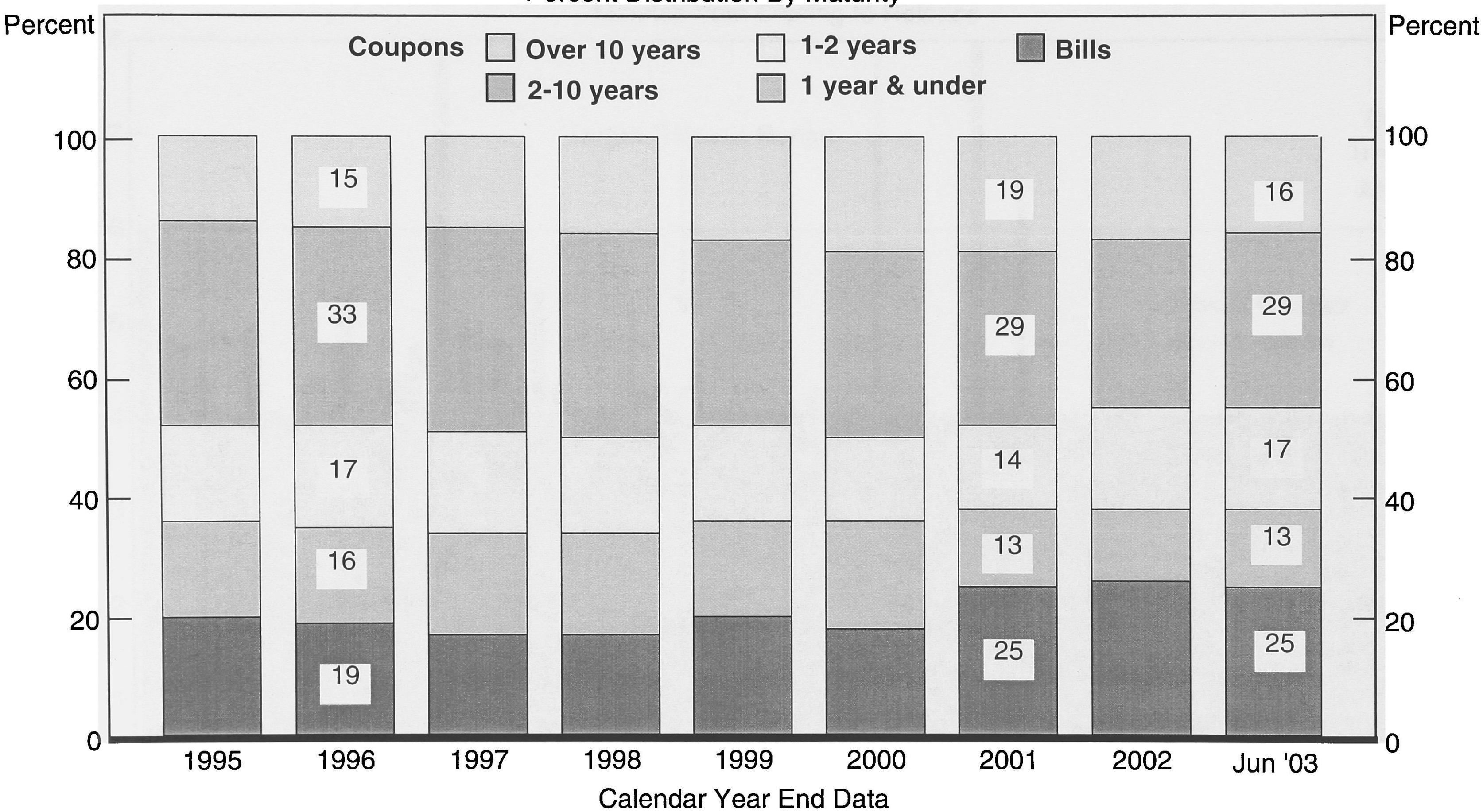
FOREIGN HOLDINGS AS A PERCENT OF TOTAL PRIVATELY HELD PUBLIC DEBT[1]



1/ Privately held debt excludes holdings of the Federal Reserve.
2/ Series for estimated foreign holdings. Data through May 31, 2003. **See http://www.treas.gov/tic/index.html.**
3/ Source: Federal Reserve Bank of New York statistical release H4.1.

PRIVATELY HELD TREASURY MARKETABLE DEBT [1]

Percent Distribution By Maturity



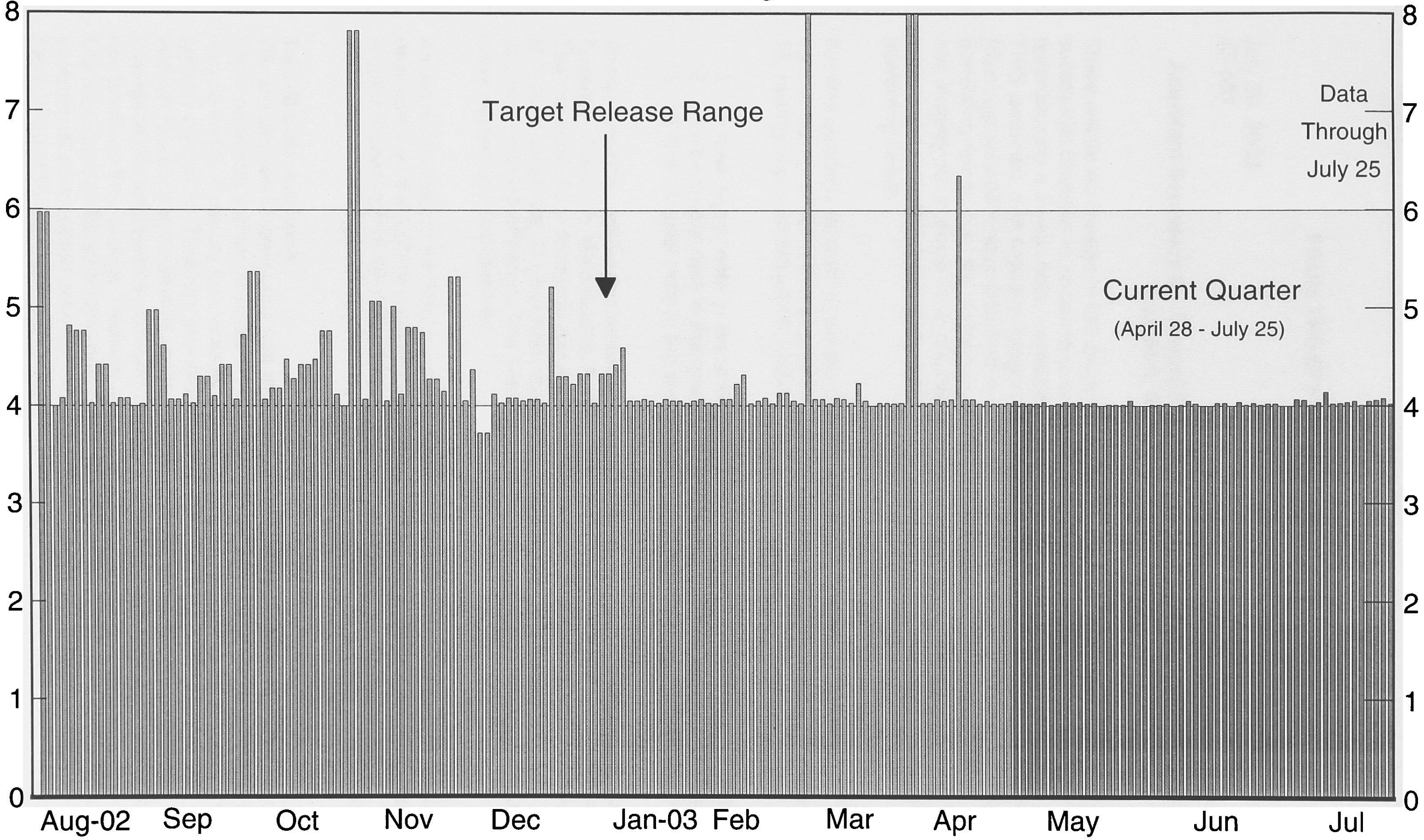
[1] Privately held marketable debt excludes holdings of the Federal Reserve and non-interest-bearing matured debt.

Department of the Treasury
Office of Market Finance

July 28, 2003-10

AUCTION RELEASE TIMES

Minutes from Closing to Release



Note: No Current Quarter Exceptions

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
JS-581

Assistant Secretary for Financial Markets Brian C. Roseboro August 2003 Quarterly Refunding Statement

There will be no change in the issuance calendar this quarter. Treasury has made substantial changes in issuance over recent quarters, diversifying our portfolio by reintroducing a 3-year note, increasing the frequency of 5-year note and 10-year TIPS issuance, and regularly reopening 10-year notes. These adjustments to the financing schedule have occurred in conjunction with an increase in our expected borrowing needs over the coming quarters. The financing changes that Treasury has already put in place have created additional capacity to accommodate the anticipated increase in issuance and flexibility to meet most unexpected swings in borrowing needs.

For this quarterly refunding, we are offering $60 billion of notes to refund approximately $43.7 billion of privately held notes and bonds maturing on August 15, raising approximately $16.3 billion. The securities are:

1. A new 3-year note in the amount of $24 billion, maturing August 15, 2006.
2. A new 5-year note in the amount of $18 billion, maturing August 15, 2008.
3. A new 10-year note in the amount of $18 billion, maturing August 15, 2013.

These securities will be auctioned on a yield basis at 1:00 p.m. Eastern time on Tuesday, August 5, Wednesday, August 6, and Thursday, August 7, respectively. The balance of our financing requirements will be met through the monthly issuance of 5-year notes, the 10-year note reopening and 10-year TIPS reopening, and 2-year note and bill offerings. The Treasury is likely to issue cash management bills in early September and October.

As we announced in the May quarterly statement, the Treasury will begin issuing 5-year notes on the 15th of each month starting in August. Treasury will also begin regular reopenings of 10-year notes on the 15th of the month following the traditional refunding, with the first 10-year reopening settling on September 15th.

Two-Minute Auctions

We are pleased to announce that effective next Monday, August 4th, Treasury will begin releasing auction results in two minutes (with a variance of +/- 30 seconds). As you know, Treasury has recently been working on improving the efficiency of the primary market for Treasury securities by reducing the time it takes to release auction results. Improvements in the auction process will generate long term savings to the taxpayer by reducing uncertainty that bidders bear and lowering the risk premium they charge Treasury in each auction. Achieving a two-minute auction has required significant technological and procedural changes, and is the result of exceptional cooperation between primary dealers and other auction participants, the Bureau of Public Debt, the Federal Reserve Bank of New York, and the press.

Change to Note Auction Schedule

Treasury will adjust its note auction schedule to avoid coinciding with FOMC announcements. The changes will reduce the uncertainty auction participants face when note auction dates fall on FOMC announcement dates. These changes will be shown in the calendars we release each quarter as part of the quarterly refunding process. These changes are being undertaken due to the significance of FOMC announcements. We do not anticipate making calendar changes for any other information releases.

Policy Issues under Discussion
The Treasury recognizes the need to have contingency plans in place for the primary market in order to respond to potential auction disruptions. Last quarter, we solicited comments from market participants on circumstances they believe would lead to an auction delay and factors we should consider when deciding whether or not to postpone an auction. This quarter we presented several possible responses to different scenarios that would likely result in a delayed auction close or a rescheduled auction. We have asked for feedback on these possible responses in an effort to refine our contingency plans further, and will continue to consult with market participants about the most suitable course of action to take.

Please send comments and suggestions on these subjects or others relating to debt management to debt.management@do.treas.gov.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 30, 2003
JS-582

Minutes Of The Meeting Of The Treasury Borrowing Advisory Committee Of The Bond Market Association

The committee convened in closed session at the Hay-Adams Hotel at 11:45 p.m. All members were present, except Mr. Axilrod, Mr. Davis, Mr. Leech, Mr. Stark, Mr. Sundaresan, and Mr. White. Assistant for Financial Markets Brian Roseboro and Deputy Assistant Secretary for Federal Finance Timothy Bitsberger welcomed the Committee, and turned the meeting over to the Chairman. The Federal Register announcement of the meeting and a list of Committee members are attached.

The meeting began with the Chairman's reading of the charge. Mr. Bitsberger then presented the charts relating to the first discussion point of the charge. The first chart illustrated Treasury projections for the July-September 2003 quarter, highlighted the large increases in financing coming from compensating balances and non-marketables (mainly from SLGSs). The second and third charts highlighted the flexibility in Treasury current issuance calendar. The fourth chart showed Treasury projected maturity profile from now into 2012. The chart also illustrated the even distribution of Treasury maturity profile. The last chart showed average maturity of marketable debt and of issuance from 1981 to 2008.

Committee members thought that Treasury current issuance schedule was adequately flexible for the foreseeable future. Committee members said that the discussed charts were greatly improved from the earlier versions. The members also believed that Treasury had ample time to make necessary financing changes to accommodate the changing budget deficits. One member also suggested that given Treasury's reliance on the bills for residual issuance Treasury could bring back 52-week bills if additional financing was required. A discussion ensued on the government budget forecast process and how that process could lead to deviations from market forecasts.

Mr. Bitsberger then moved to the second question of the charge. He presented a chart to show that during the period of December 1992 to June 2003 the on-the-run premium for the 2-year auctions that coincided with the FOMC announcements averaged 2bps point lower than the other auctions.

Some Committee members felt that it was difficult to draw a definitive conclusion given the small number of recent observations of FOMC announcements coinciding with note auctions. Some Committee members believed that the results of the analysis might be biased by Treasury policy changes, such as auction format and the shortening of the auction outcome release time. The Committee members also questioned whether moving auctions for FOMC announcements would set a precedent for moving auctions to avoid other potentially market-moving releases; ultimately endangering the regularity of Treasury's auction schedule.

The Committee was split on their recommendation of whether to move note auction. A slim majority (seven members) believed Treasury should change the auction calendar. The majority argued that Treasury should change the auction calendar since it was simple to implement and there was some evidence that the uncertainty associated with the FOMC announcements was costly. Those voting against the move believed that it was not necessary for Treasury to change its calendar because there was ample time between auction release time and the time of the FOMC announcements for the market to adjust and the move could set a precedent in disrupting auction regularity.

Mr. Bitsberger then presented charts on Treasury's issuance of long-term securities. The charts highlighted the importance to Treasury of regular and predictable issuance and flexibility to quickly raise and pay-down cash in response to uncertain fiscal needs.

In the discussion of the costliness of long-term issuance, Committee members expressed a wide range of views. Some noted the lack of demand for long-term securities, illustrated by the 10-year to 30-year spread. One member argued that there was a public good aspect to long-term issuance although another noted that Treasury should not raise its borrowing costs to provide public goods. Some members noted that there may be benefits of long-term issuance if borrowing needs greatly increase over the next 30 years. In general Committee members felt that, while issuance of 30-year bonds may not currently be appropriate, it might be sometime in the future.

Some Committee members also raised the question of what in Treasury's analysis separated 30-year bond issuance from 10-year note issuance. Treasury officials noted that, unlike the 10-year note, small bond issuance ultimately came to dominate the portfolio. Some Committee members also felt that the investor base for the long-dated securities may grow over time. Other Committee members felt that without a risk free long term instrument it would be difficult for the market to transfer long-term risk. The benefits of more efficient risk transfer or hedging would outweigh the relative higher costs of the long bond.

On the flexibility factor, the Committee members believed that Treasury should manage risk by doing a stress analysis that included the optimistic and pessimistic budget scenarios. Some members felt that the long bond might make sense if Treasury considered the possible increase in government liabilities due to programs such as Medicare and Social Security.

In summary, the Committee felt that Treasury had made a case that the long bond was not needed at the current time but there could be a case for the long bond sometime in the future. The Committee was also concerned that the lack of a long-term risk-free instrument made long-term risk transfer difficult. The Committee also thought that debt management would benefit from the improvement in government budget forecasts.

The Committee then discussed financing requirements for this quarter. Members suggested that Treasury should consider the minimum auction sizes for 5-year and 10-year notes in the current environment to be $18 billion. Committee members noted the elevated level of fails in the 10-year and projected financing requirements as the basis for recommending somewhat larger sizes.

The meeting adjourned at 1:50 p.m.

The Committee reconvened at the Hay-Adams Hotel at 5:30 p.m. All members were present, except Mr. Axilrod, Mr. Davis, Mr. Keller, Mr. Leech, Mr. Stark, Mr. Sundaresan, and Mr. White. The Chairman presented the Committee report to the Assistant Secretary for Financial Markets, Brian Roseboro, and Deputy Assistant Secretary for Federal Finance, Tim Bitsberger. A brief discussion followed the Chairman's presentation, but did not raise significant questions regarding the report's content.

The meeting adjourned at 5:50 p.m.

Jeff Huther
Deputy Director

Office of Market Finance
July 29, 2003

Certified by:
Timothy W. Jay, Chairman
Treasury Borrowing Advisory Committee
of The Bond Market Association
July 29, 2003

Treasury Borrowing Advisory Committee Quarterly Meeting

Committee Charge

Long-Term Financing
The Administration recently estimated that the deficit will be higher than earlier anticipated, $455 billion in FY2003 and $475 billion in FY2004. The Administration has also pledged to cut the deficit in half in the next few years. We will show you a few charts that describe projections of our future financing needs and interest costs given current issuance. We would like the Committee's advice on whether the recent adjustments to the financing schedule provide Treasury with sufficient debt management tools to handle the consequent increases or decreases in debt issuance while facilitating our primary objective of meeting the government's financing needs at the lowest cost over time.

FOMC Calendar Changes
From time to time, FOMC announcements occur on Treasury note auction dates. Our analysis suggests that coincident dates of FOMC announcements and note auctions raise our borrowing costs (see chart). We would like the Committee's advice on whether Treasury should consider adjusting its note auction schedule to avoid coinciding with FOMC announcement dates. If so, what adjustments to the note auction calendar would the Committee recommend.

Treasury's Issuance of Long-Term Securities
We will show you several charts highlighting the factors that influence Treasury's long-term issuance. We would like the Committee's comments on these charts and the relevance of these factors.

Financing this Quarter
We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $43.7 billion of privately held notes and bonds maturing on August 15 (this includes $1.3 billion of the 8 3/8% 8/15/03-08 that was called on 4/15/03).
- The composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills if necessary.
- The composition of Treasury marketable financing for the October-December quarter.

Report(s):

- Q3 Tables
- Q4 Tables

U.S. TREASURY FINANCING SCHEDULE FOR 3RD QUARTER 2003

BILLIONS OF DOLLARS

ISSUE	ANNOUNCEMENT DATE	AUCTION DATE	SETTLEMENT DATE	OFFERED AMOUNT 4-WK	OFFERED AMOUNT 3-MO	OFFERED AMOUNT 6-MO	MATURING AMOUNT	NEW MONEY
4-WEEK AND 3&6 MONTH BILLS	6/26	6/30	7/3	17.00 A	17.00 A	18.00 A	48.56	3.44
	7/3	7/7	7/10	17.00 A	17.00 A	18.00 A	51.72	0.28
	7/10	7/14	7/17	8.00 A	16.00 A	18.00 A	42.72	-0.72
	7/17	7/21	7/24	10.00 A	15.00 A	17.00 A	41.13	0.87
	7/24	7/28	7/31	20.00 A	16.00 A	17.00 A	47.66	5.34
	7/31	8/4	8/7	20.00	16.00	17.00	49.00	4.00
	8/7	8/11	8/14	20.00	16.00	17.00	38.00	15.00
	8/14	8/18	8/21	25.00	16.00	16.00	42.00	15.00
	8/21	8/25	8/28	25.00	16.00	16.00	53.00	4.00
	8/28	9/1	9/4	16.00	16.00	16.00	54.00	-6.00
	9/4	9/8	9/11	16.00	16.00	15.00	55.00	-8.00
	9/11	9/15	9/18	11.00	16.00	15.00	60.00	-18.00
	9/18	9/22	9/25	16.00	16.00	15.00	59.00	-12.00
					645.00		641.79	3.22
CASH MANAGEMENT BILLS								
12-Day Bill Matures 9/15	8/28	9/2	9/3		20.00		20.00	0.00
COUPONS								
						CHANGE IN SIZE		
10-Year TIPS	7/7	7/9	7/15		11.00 A	+5.00	0.00	11.00
2-Year Note	7/21	7/23	7/31		25.00 A		11.01	13.99
3-Year Note	7/30	8/5	8/15		25.00	+3.00		
5-Year Note	7/30	8/6	8/15		20.00	+2.00		
10-Year Note	7/30	8/7	8/15		20.00	+2.00	43.69	21.31
2-Year Note	8/25	8/27	9/2		24.00	-1.00	13.08	10.93
5-Year Note	9/8	9/10	9/15		20.00			
10-Year Note (R)	9/8	9/11	9/15		16.00	-4.00	0.00	36.00
2-Year Note	9/22	9/24	9/30		24.00		16.14	7.86
					185.00		83.91	101.09

R = Reopening
A = Announced

Treasury announced a Q3 borrowing need of $104 billion on 7/28/03.

NET CASH RAISED THIS QUARTER: 104.30

U.S. TREASURY FINANCING SCHEDULE FOR 4TH QUARTER 2003
BILLIONS OF DOLLARS

ISSUE	ANNOUNCEMENT DATE	AUCTION DATE	SETTLEMENT DATE	OFFERED AMOUNT 4-WK	OFFERED AMOUNT 3-MO	OFFERED AMOUNT 6-MO	MATURING AMOUNT	NEW MONEY
4-WEEK AND 3&6 MONTH BILLS	9/25	9/29	10/2	16.00	16.00	15.00	50.00	-3.00
	10/2	10/6	10/9	16.00	16.00	15.00	49.00	-2.00
	10/9	10/13	10/16	12.00	17.00	15.00	42.00	2.00
	10/16	10/20	10/23	18.00	18.00	16.00	47.00	5.00
	10/23	10/27	10/30	20.00	18.00	16.00	48.00	6.00
	10/30	11/3	11/6	20.00	18.00	16.00	47.00	7.00
	11/6	11/10	11/13	20.00	17.00	17.00	42.00	12.00
	11/13	11/17	11/20	22.00	17.00	17.00	50.00	6.00
	11/20	11/24	11/28	22.00	16.00	17.00	52.00	3.00
	11/27	12/1	12/4	18.00	16.00	17.00	54.00	-3.00
	12/4	12/8	12/11	16.00	16.00	17.00	54.00	-5.00
	12/11	12/15	12/18	12.00	15.00	16.00	56.00	-13.00
	12/18	12/22	12/26	16.00	15.00	16.00	56.00	-9.00
					653.00		647.00	6.00
CASH MANAGEMENT BILLS								
12-Day Bill Matures 12/15	12/1	12/2	12/3		20.00		20.00	0.00
COUPONS						CHANGE IN SIZE		
5-Year Note	10/5	10/8	10/15		20.00			
10-Year TIPS (R)	10/5	10/9	10/15		10.00	-1.00	0.00	30.00
2-Year Note	10/27	10/29	10/31		25.00	+1.00	18.78	6.22
3-Year Note	11/5	11/12	11/17		25.00			
5-Year Note	11/5	11/13	11/17		20.00			
10-Year Note	11/5	11/14	11/17		20.00		24.81	40.19
2-Year Note	11/24	11/26	12/1		25.00		19.97	5.03
5-Year Note	12/8	12/10	12/15		20.00			
10-Year Note (R)	12/8	12/11	12/15		16.00		0.00	36.00
2-Year Note	12/19	12/23	12/31		25.00		22.17	2.83
					206.00		85.73	120.27

R = Reopening
A = Announced

Treasury announced a Q4 borrowing need of $126 billion on 7/28/03

NET CASH RAISED THIS QUARTER: 126.27

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 30, 2003
JS-583

Report To The Secretary Of The Treasury From The Treasury Borrowing Advisory Committee Of The Bond Market Association

July 29, 2003

Dear Mr. Secretary:

Since the Committee's last meeting on April 30th, the economy has continued to expand at a modest pace. Upcoming data should show that the economy grew by less than 2.0% on an annualized basis in the second quarter, this after a 1.4% growth rate in the first quarter. Additionally, the labor market remained weak with the average duration of unemployment lengthening to nearly 20 weeks or five months. However, despite these signs of ongoing weakness, there have also been some hopeful economic data: surveys of supply managers have suggested that the manufacturing activity is stabilizing or improving and the June orders data suggested that growth may continue to build.

Disinflation continues to be a major theme in the market. Since our last meeting, the annual rate of inflation has slipped even lower and is now running at just 2.1%, down from 2.4% at the end of last year. With the unemployment rate well above NAIRU and capacity utilization under 75%, further disinflation is likely, a fact that the Federal Reserve recently acknowledged.

The Treasury market has seen an increase in volatility since our last meeting with three-month 10-year annualized swap volatility rising to almost 136 basis points from 110 basis points as a high degree of uncertainty regarding Federal Reserve policy and the inflation outlook weighed on the markets. Two-year yields have risen, up 12 basis points to 1.61% despite having fallen to a yield of 1.08% during the period. Ten-year notes also sold off during the inter-meeting period, rising 46 basis points despite having fallen to as low as 3.11% and the 2-year/10-year curve steepened by 34 basis points.

Equity markets continued to improve since our last meeting. The S&P 500 index has risen roughly 9% while the NASDAQ composite index is up over 18% during the inter-meeting period. Volatility, as measured by the VIX index, a weighted average of implied volatilities on S&P 100 index options, has fallen by roughly 16% since our last meeting.

Market estimate show that sizable budget deficits are likely here for the foreseeable future. Many forecasters now expect budget deficits to total over $3 trillion over the next decade.

Against this economic and financial backdrop, the Committee began consideration of debt management questions included in the quarterly meeting Committee charge.

The first question referred to long-term financing at Treasury and was accompanied by a set of related charts. The question asked whether recent adjustments to the financing schedule provided Treasury with sufficient debt management tools to handle the consequent increases or decreases in debt issuance while facilitating their primary objective of meeting the government's financing needs at the lowest possible cost over time.

The first chart described the Treasury's financing requirements including deficit funding, means of financing and net marketable financing. Of note, Treasury mentioned a smaller actual compensating balance and larger net non-marketable financing due to an increase in SLGS (State and Local Government Securities Issuance).

The next chart depicted financing residuals given the current issuance schedule. This chart showed that the current issuance pattern could handle a broad range of variance within one standard deviation of change and that the bill market could absorb this issuance change.

The next chart looked at bills as a percentage of the Treasury's marketable debt. It highlighted the flexibility of the bill market structure and its ability to absorb financing changes.

The next chart illustrated the maturity profile of outstanding Treasury marketable coupons. It showed that as Treasury has increased its issuance, the amount of debt to roll over has increased. It also showed that the distribution of maturities in each quarter are very similar going forward.

The final chart depicted the average maturity of Treasury's marketable debt and the average maturity of its issuance. The noteworthy observation here was that Treasury has made significant changes to coupon issuance without a large affect on average maturity. That is to say that their redistribution of issuance recently to longer dated securities has little affect on the average maturity of the debt.

There was consensus among the members of the Committee that the current financing schedule was flexible and adequate for the foreseeable future. Members also observed that the bill market had enough capacity to absorb any near-term changes in issuance, and further noted that if more capacity were needed in bills, one-year bill issuance could be considered. One member observed that even if the deficit were to drop dramatically, the current schedule would allow enough time to adjust for this change.

The next topic addressed the occurrence of FOMC announcements on Treasury note auction dates. The accompanying slide illustrated that coincident dates of FOMC announcements and 2-year note auctions increased borrowing costs as measured by the current issue versus the off-the-run curve. Treasury then asked for the Committee to comment on whether they should consider adjusting their note auction schedule to avoid coinciding with FOMC announcement dates.

A number of Committee members observed that the actual number of occurrences where the pricing at auction indicated a discount due to an FOMC statement release was few. While the data suggested investors tended to hold back from participating in auctions around FOMC announcements, the bid-to-cover ratios indicated otherwise. The Committee also observed that the efficiency of the auction process has provided participants with over an hour to offset their risks prior to any FOMC announcement. Finally, one member observed that it was not difficult to move an auction by a day and that it would benefit the Treasury to do so. As Treasury set its calendar one year in advance while the FOMC fixed its meeting schedule two years in advance, the Committee recommended that on the dates where issuance coincides with FOMC meetings, Treasury should adjust their calendar.

The Committee voted whether to recommend to Treasury to adjust auction dates to not coincide with FOMC announcements. The results were seven in favor, six against, one abstention.

Next Treasury presented a number of charts highlighting factors that influence their long-term issuance and asked for the Committee's comments on these charts and on the relevance of the factors.

The first set of slides mentioned Treasury debt management's guiding principles which included low borrowing cost over time through regular and predictable issuance as well as the need for borrowing flexibility in order to manage cash balances. The presentation also included issues not affecting borrowing policy such as current interest rates, the annual budget deficit and short-term fluctuations in demand. Another slide showed various methods Treasury used to implement their debt management policy.

The next slide group described the high cost of longer-term issuance relative to shorter-term issuance in two ways. First, it compared the cost of issuing 10-year securities with one-year bills over the last 50 years and second, it analyzed the 10-30 year spread since 1977. In both cases, the longer duration debt was significantly more costly to Treasury over the relevant time periods than the short-dated issuance.

Treasury currently believes that the lowest cost issuance over time requires a diversified debt portfolio and the next two slides explained the rationalization for a diversified portfolio as well as the characteristics of their current portfolio which made it well diversified. One Committee member commented that since Treasury could not predict the future, it was difficult to know what actually constituted the lowest cost issuance over time. Most agreed, however, that Treasury's job was to try to predict the future primarily by using data from the past and that a diversified debt portfolio would best meet their needs.

Treasury then depicted the outsized cost of long-term issuance in the portfolio mix and the compromised flexibility caused by normal bond issuance. In effect, long-dated bond issuance represented 3% of all annual issuance from 1980-2001. It also comprised 17% of all debt outstanding. Additionally, that long-dated issuance represented almost one third of Treasury's interest expense over that period and in a declining interest rate environment. Excessive long bond issuance reduced Treasury's borrowing flexibility and ultimately reduced Treasury's ability to be regular, predictable and transparent. Most Committee members agreed with Treasury and felt that too many long-dated securities were issued previously. They also agreed that if Treasury had been doing similar analysis in the 1980's and 1990's to what they were doing today, they might have approached long-dated issuance policy differently.

The remainder of the slides addressed the need for flexibility in Treasury borrowing policy and the difficulty attaining that flexibility using long-dated issuance. Some relevant points were (1) Treasury financing needs were volatile and uncertain; (2) the investor base for long-term debt was ill suited for high frequency auctions; and (3) long-term debt hampered regular and predictable issuance in improving fiscal environments.

The Committee then commented on Treasury's conclusions which were; (1) for Treasury to achieve their stated goals, they should weight issuance towards less costly and more flexible shorter maturities; and (2) long-dated bond issuance was expensive, inflexible and unnecessary for managing risks in the current environment. One Committee member implied that market timing by Treasury might actually lead to low-cost borrowing over time, but the overwhelming majority felt that predictability and transparency probably saved Treasury far more in the long run than being right at timing the market. Another member felt that more long-dated issuance might promote low-cost borrowing over time by allowing asset managers to more easily adjust liabilities thereby promoting liquidity in the long end of the market. Most members, however, did not agree, believing that current analysis just did not support that conclusion.

Several members described current issuance policy as "a localized solution" and that it might not withstand a stress test where debt issuance increased dramatically in the near future. Treasury responded, however, that they operated on a cash rather than on an accrual accounting basis. Thus, they had to use central OMB forecasts plus standard deviations for planning purposes. Additionally, as a rule, they left longer term appropriation issues to Congress.

The Committee then addressed the question of composition of Treasury notes to refund approximately $43.7 billion of privately held notes and bonds maturing on August 15, 2003 (including $1.3 billion of the 8-3/8% 8/15/03-08 that was called on 4/15/03) as well as the composition of Treasury marketable financing for the remainder of the July-September quarter and for the October-December quarter.

Consistent with the scenario from Treasury, to refund $43.7 billion of privately held notes and bonds maturing on August 15, 2003, the Committee recommended a $25 billion 3-year note due August 15, 2006, a $20 billion 5-year note due August 15, 2008, and a $20 billion 10-year note due August 15, 2013. For the remainder of the quarter, the Committee recommended two $24 billion 2-year notes as well as a $20 billion 5-year note issued in September and $16 billion of a re-opened 10-year note issued in September and due August 15, 2013. For the October-December quarter, the Committee recommended financing as contained in the attached table. Relevant features include three $25 billion monthly 2-year notes, three $20 billion monthly 5-year notes, a $25 billion 3-year note for issuance in November and a $20 billion 10-year note issued in November followed by a $16 billion re-opening of that 10-year note in December. The Committee further recommended a $10 billion re-opening of the TIIS due July 15, 2013.

Respectfully submitted,

Timothy W. Jay
Chairman

Mark B. Werner
Vice Chairman

Attachments (2)

Report(s):

- Q3 Tables
- Q4 Tables

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
July 21, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	July 24, 2003
Maturity Date:	October 23, 2003
CUSIP Number:	912795NT4

High Rate: 0.895% Investment Rate 1/: 0.911% Price: 99.774

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 26.59%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 27,346,727	$ 13,302,638
Noncompetitive	1,417,368	1,417,368
FIMA (noncompetitive)	280,000	280,000
SUBTOTAL	29,044,095	15,000,006 2/
Federal Reserve	4,802,668	4,802,668
TOTAL	$ 33,846,763	$ 19,802,674

Median rate 0.885%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.850%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 29,044,095 / 15,000,006 = 1.94

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,140,936,000

JS-565

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
July 21, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	July 24, 2003
Maturity Date:	January 22, 2004
CUSIP Number:	912795PG0

High Rate: 0.950% Investment Rate 1/: 0.970% Price: 99.520

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 30.75%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 29,939,240	$ 15,978,866
Noncompetitive	921,172	921,172
FIMA (noncompetitive)	100,000	100,000
SUBTOTAL	30,960,412	17,000,038 2/
Federal Reserve	6,072,102	6,072,102
TOTAL	$ 37,032,514	$ 23,072,140

Median rate 0.940%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.900%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 30,960,412 / 17,000,038 = 1.82

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $690,940,000

JS-586

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.
July 21, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $10,000 million to refund an estimated $12,000 million of publicly held 4-week Treasury bills maturing July 24, 2003, and to pay down 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 $13,592 million of the Treasury bills maturing on July 24, 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 587

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED JULY 24, 2003

July 21, 2003

Offering Amount	$10,000 million
Maximum Award (35% of Offering Amount)	$ 3,500 million
Maximum Recognized Bid at a Single Rate	$ 3,500 million
NLP Reporting Threshold	$ 3,500 million
NLP Exclusion Amount	$10,900 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 NJ 6
Auction date	July 22, 2003
Issue date	July 24, 2003
Maturity date	August 21, 2003
Original issue date	February 20, 2003
Currently outstanding	$42,628 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 daylight saving time on auction day

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

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

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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

EMBARGOED UNTIL 11:00 A.M.
July 21, 2003

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 2-YEAR NOTES

The Treasury will auction $25,000 million of 2-year notes to refund $11,007 million of publicly held notes maturing July 31, 2003, and to raise new cash of approximately $13,993 million.

In addition to the public holdings, Federal Reserve Banks hold $4,996 million of the maturing notes for their own accounts, which may be refunded by issuing an additional amount of the new security.

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

TreasuryDirect customers requested that we reinvest their maturing holdings of approximately $522 million into the 2-year note.

The auction will be conducted in the single-price auction format. All competitive and noncompetitive awards will be at the highest yield of accepted competitive tenders. The allocation percentage applied to bids awarded at the highest yield will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

The notes being offered today are eligible for the STRIPS program.

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-588

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED JULY 31, 2003

July 21, 2003

Offering Amount	$25,000 million
Maximum Award (35% of Offering Amount)	$ 8,750 million
Maximum Recognized Bid at a Single Rate	$ 8,750 million
NLP Reporting Threshold	$ 8,750 million

Description of Offering:

Term and type of security	2-year notes
Series	N-2005
CUSIP number	912828 BE 9
Auction date	July 23, 2003
Issue date	July 31, 2003
Dated date	July 31, 2003
Maturity date	July 31, 2005
Interest rate	Determined based on the highest accepted competitive bid
Yield	Determined at auction
Interest payment dates	January 31 and July 31
Minimum bid amount and multiples	$1,000
Accrued interest payable by investor	None
Premium or discount	Determined at auction

STRIPS Information:

Minimum amount required	$1,000
Corpus CUSIP number	912820 JB 4
Due date(s) and CUSIP number(s) for additional TINT(s)	July 31, 2005 - - 912833 ZM 5

Submission of Bids:

Noncompetitive bids:

Accepted in full up to $5 million at the highest accepted yield.

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

Competitive bids:

(1) Must be expressed as a yield with three decimals, e.g., 7.123%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all yields, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

Noncompetitive tenders:

Prior to 12:00 noon eastern daylight saving time on auction day

Competitive tenders:

Prior to 1:00 p.m. eastern daylight saving time on auction day

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

FROM THE OFFICE OF PUBLIC AFFAIRS

July 22, 2003
js-589

Ohio Launches Federal Health Coverage Tax Credit

Today, Treasury Secretary John Snow applauded Governor Taft for launching Ohio's efforts under the federal Health Coverage Tax Credit Program (HCTC) that will help cover the cost of health insurance premiums for many Ohio residents.

"I am pleased that Governor Taft, Insurance Director Womer Benjamin, and interested parties in the state of Ohio have worked so hard to make the Health Coverage Tax Credit program available to up to 12,000 workers and their families," stated Treasury Secretary John Snow.

"I commend them for their leadership in this unique partnership between state and federal governments, labor and participating health plans. This program is a real innovation in tax policy, one that we hope will lead the way for other innovations that help real people obtain the health care coverage that they need in a flexible and reliable way.

We want to ensure that those who qualify for the credit get the help they need as quickly as possible. "I know many of my fellow Buckeyes have worked in important industries, such as steel, that helped build this country, to make it as strong as it is. The Health Coverage Tax Credit is one way we can give back to them. It's a bold step in the direction of affordable health care for all Americans.

The HCTC advance payments program begins nationally in August 2003. The Trade Adjustment Assistance Act President Bush signed into law last year included the new Health Coverage Tax Credit (HCTC). This program provides an advanced payment of 65% of the premium cost for a qualified health plan for individuals who are eligible to receive Trade Adjustment Assistance (TAA) benefits or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

For more information on a particular state and the health insurance programs that qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: HCTC.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

July 22, 2003
2003-7-22-13-33-49-11348

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 $81,941 million as of the end of that week, compared to $81,453 million as of the end of the prior week.

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

	June 27, 2003			July 4, 2003		
TOTAL		81,453			81,941	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	7,585	13,139	20,723	7,611	13,303	20,914
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,353	2,638	14,991	12,474	2,671	15,145
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]			23,084			23,180
3. Special Drawing Rights (SDRs) [2]			11,611			11,659
4. Gold Stock [3]			11,044			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	June 27, 2003			July 4, 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

	June 27, 2003			July 4, 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:

l/ 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, ınd 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

July 22, 2003
2003-7-22-14-11-0-11849

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 $81,438 million as of the end of that week, compared to $81,941 million as of the end of the prior week.

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

	July 4, 2003			July 11, 2003		
TOTAL		81,941			81,438	
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	7,611	13,303	20,914	7,514	13,353	20,866
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,474	2,671	15,145	12,235	2,681	14,916
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]			23,180			23,029
3. Special Drawing Rights (SDRs) [2]			11,659			11,583
4. Gold Stock [3]			11,044			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	July 4, 2003			July 11, 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

	July 4, 2003			July 11, 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:

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

Reserves for the prior week are final.

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

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

FROM THE OFFICE OF PUBLIC AFFAIRS

July 22, 2003
js-590

Treasury and IRS Address Interaction of Stapled Stock and Foreign Tax Credit Rules

Today, the Treasury Department and the IRS issued Notice 2003-50 addressing the interaction of the stapled stock rules under Code section 269B and the foreign tax credit limitation rules. The transaction addressed in the Notice involves a corporate taxpayer that structures its group so that some or all of its foreign subsidiaries are held through a foreign subsidiary, the stock of which is subject to restrictions that permit its stock to be transferred only if stock of a domestic affiliate is also transferred. In other words, the stock of the two subsidiaries is "stapled" together.

The foreign tax credit rules generally require an affiliated group of corporations to determine the foreign tax credits that reduce its U.S. income tax liability by applying the foreign tax credit limitation on a combined basis across all of the corporations in the group. In the transactions addressed in the Notice, a taxpayer establishes a stapled stock structure and takes the position that the foreign tax credit limitation can be determined without the inclusion of the foreign subsidiaries. The Notice provides that notwithstanding the stapling transaction the foreign subsidiaries are included in the combined group for purposes of computing the foreign tax credit limitation.

The text of the Notice 2003-50 follows:

Part III - Administrative, Procedural, and Miscellaneous
Treatment of foreign stapled entity under section 269B as domestic for purposes of sections 904(i) and 864(e)

Notice 2003-50
This notice modifies Notice 89-94, 1989-2 C.B. 416.

Section 269B provides that, except as provided in regulations, if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation will be treated as a domestic corporation for U.S. income tax purposes. Section 269B(a)(1). Two entities are stapled entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests. Section 269B(c)(2). Interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms and conditions, in connection with the transfer of one of the interests the other interest is also transferred or required to be transferred. Section 269B(c)(3).

Notice 89-94 announced that regulations issued under section 269B will provide that a stapled foreign corporation, treated as a domestic corporation under section 269B(a)(1), will nevertheless be treated as a foreign corporation for purposes of the definition of an includible corporation under section 1504(b). Thus, losses of a stapled foreign corporation will not be allowed to offset income of any member of an affiliated group, unless a valid section 1504(d) election is in effect with respect to the stapled foreign corporation.

Section 904(i) provides that if two or more domestic corporations would be members of the same affiliated group if (i) section 1504(b) were applied without regard to the exceptions contained therein, and (ii) the constructive ownership rules of section 1563(e) applied for purposes of section 1504(a), the Secretary is authorized to issue regulations that provide for resourcing the income of any of such domestic corporations or for modifications to the consolidated return regulations to the extent that such resourcing or modifications are necessary to prevent the avoidance of the provisions of this subpart (sections 901 to 908). Section 904(i) was enacted to prevent a consolidated group of corporations from manipulating its foreign tax credit limitation by utilizing techniques to disaffiliate a subsidiary. See H.R. Rep. No. 101-247, at 1292-93 (1989).

The regulations under section 904(i) provide that two includible corporations that are "affiliates" (as defined in §1.904(i)-1(b)(1)) must consistently elect either to credit or to deduct foreign income taxes paid or accrued (or deemed paid) for the taxable year and require the affiliates to determine their foreign tax credit limitations on a combined basis. §1.904 (i)-1(a), (d). In order to be an "affiliate" under §1.904(i)-1(b), a corporation must be an includible corporation under section 1504(b). See §1.904(i)-1 (b)(1)(i) and -1(b)(2).

Section 864(e)(1) requires the members of an affiliated group to allocate and apportion interest expense as if all members of the group were a single corporation. Section 864(e)(5) provides that, except for certain financial institutions, the term "affiliated group" has the same meaning as in section 1504 (determined without regard to section 1504(b)(4)). Section 864(e)(1) was enacted because Congress was concerned that the separate company approach for allocating and apportioning expenses did not reflect economic reality. Instead, consideration of the expenses of an entire group of corporations that file a consolidated income tax return is a more appropriate approach. In addition, Congress wanted to prevent an affiliated group from manipulating its foreign tax credit limitation by adjusting the location of borrowing within the affiliated group. H.R. Rep. No. 99-426, at 374-75 (1985); S. Rep. No. 99-313, at 346-47 (1986).

Sections 1.861-11 and 1.861-11T contain rules for allocating and apportioning interest expense of an affiliated group. For purposes of these rules, the definition of an "affiliated corporation" is expanded to include any "includible corporation" (as defined in section 1504(b) without regard to section 1504(b)(4)) if 80 percent of the vote or value of all the stock is owned directly or indirectly by an includible corporation or by members of an affiliated group. § 1.861-11T(d)(6). This expanded definition was intended to prevent taxpayers from avoiding application of section 864(e) (1) through disaffiliation of one member or the creation of two affiliated groups.

Treasury and the IRS are aware that certain taxpayers have imposed transfer restrictions on the stock of an 80 percent or greater owned foreign corporation and taken the position that such stock is stapled to the stock of an 80 percent or greater owned domestic corporation. If the interests of the corporations are treated as stapled for purposes of section 269B, then although the foreign corporation generally is treated as a domestic corporation, Notice 89-94 announced that regulations will be issued that would treat it as a foreign corporation for purposes of the definition of an includible corporation under section 1504(b) and therefore not an includible corporation.

This notice announces that regulations issued under section 269B will provide that a foreign corporation that is stapled to a domestic corporation will be treated as a domestic corporation for purposes of the definition of an includible corporation under section 1504(b) when applying §§ 1.904(i)-1 and 1.861-11T(d)(6). The provisions of the regulations described in the preceding sentence will be effective for taxable years beginning after July

22, 2003. In the case of structures completed on or after July 22, 2003, such provisions will be effective for taxable years including July 22, 2003.

The IRS will continue to apply principles of existing law to determine whether interests are stapled for purposes of section 269B. For example, under a substance-over-form analysis, restrictions on transferability of ownership interests may be disregarded for tax purposes if the interests are held by the same person or related persons. Finally, Treasury and the IRS are considering issuing further guidance under section 269B, including guidance on situations where the interests of two or more entities are held by the same person or related persons.

EFFECT ON OTHER NOTICES
Notice 89-94, 1989-2 C.B. 416, is modified.

DRAFTING INFORMATION
The principal authors of this notice are Kenneth Allison and Bethany Ingwalson of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice contact Mr. Allison at (202) 622-3860 or Ms. Ingwalson at (202) 622-3850 (not toll-free calls).

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 23, 2003
JS-591

Treasury works to Stem the Inappropriate use of Life Insurance and Annuity Contracts

Today, the Treasury Department and the Internal Revenue Service issued two revenue rulings designed to curtail the abusive use of life insurance and annuity contracts to avoid current taxation on investment earnings. Life insurance and annuity contracts receive favorable treatment under the Internal Revenue Code, including deferring tax on the investment earnings of those contracts, because they serve important goals, specifically providing life insurance protection or a means of saving for retirement.

In recent years, the sale of life insurance and annuity contracts "wrapped" around other investments has proliferated. These arrangements seek to defer tax on the investment earnings of those contracts. The Treasury Department believes that these life insurance contracts and annuity contracts are purchased primarily as a way to avoid current taxation on investment earnings and not for life insurance protection or a means of saving for retirement.

Revenue Ruling 2003-91 and Revenue Ruling 2003-92 will curtail the purchase of life insurance and annuity contracts primarily for tax avoidance purposes. These revenue rulings are an important step in the Treasury Departments ongoing efforts to prevent taxpayers from using insurance products and insurance companies as a means to shelter income from current taxation.

Attachments:

Related Documents:

- Revenue Ruling 2003-91
- Revenue Ruling 2003-92

Part I

Section 61. B Gross Income Defined

26 CFR 1.61-1: Gross Income
(Also ' ' 801, 817; 1.817-5)

Rev. Rul. 2003-91

ISSUE

Under the facts set forth below, will the holder of a variable contract be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract? Will income earned on those assets be included in the income of the holder in the year in which it is earned?

FACTS

Situation 1: IC is a life insurance company subject to tax under ' 801 of the Internal Revenue Code. In states where it is authorized to do so, IC offers variable life and variable annuity contracts that qualify as variable contracts under ' 817(d) (AContracts@).

The assets that fund the Contracts are segregated from the assets that fund IC=s traditional life insurance products. IC maintains a separate account (ASeparate Account@) for the assets funding the Contracts, and the income and liabilities associated with the Separate Account are maintained separately from IC=s other accounts.

The Separate Account is divided into various sub-accounts (ASub-accounts@). Each Sub-account=s assets and liabilities are maintained separately from the assets and liabilities of other Sub-accounts. Interests in the Sub-accounts are not available for sale to the public. Rather, interests in the Sub-accounts are available solely through the purchase of a Contract. IC engages an independent investment advisor ("Advisor") to manage the investment activities of each Sub-account.[1] Each Sub-account will at all times meet the asset diversification test set forth in ' 1.817-5(b)(1) of the Income Tax Regulations.

Twelve sub-accounts are currently available under the Contracts, but IC may increase or decrease this number at any time. However, there will never be more than 20

[1] For these purposes, the term investment officer refers to anyone whose responsibilities include giving investment advice or making investment decisions relating to assets held in a Sub-account and to any person who directly or indirectly supervises the work performed by such individual.

Sub-accounts available under the Contracts. Each Sub-account offers a different investment strategy. The currently available Sub-accounts include a bond fund, a large company stock fund, an international stock fund, a small company stock fund, a mortgage backed securities fund, a health care industry fund, an emerging markets fund, a money market fund, a telecommunication fund, a financial services industry fund, a South American stock fund, an energy fund and an Asian markets fund.

An individual ("Holder") purchases a life insurance Contract ("LIC"). At the time of purchase, Holder specifies the allocation of premium paid among the then available Sub-accounts. Holder may change the allocation of premiums at any time, and Holder may transfer funds from one Sub-account to another. Holder is permitted one transfer between Sub-accounts without charge per thirty-day period. Any additional transfers during this period are subject to a fee assessed against the cash value of LIC.

There is no arrangement, plan, contract, or agreement between Holder and IC or between Holder and Advisor regarding the availability of a particular Sub-account, the investment strategy of any Sub-account, or the assets to be held by a particular sub-account. Other than Holder's right to allocate premiums and transfer funds among the available Sub-accounts as described above, all investment decisions concerning the Sub-accounts are made by IC or Advisor in their sole and absolute discretion. Specifically, Holder cannot select or recommend particular investments or investment strategies. Moreover, Holder cannot communicate directly or indirectly with any investment officer of IC or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a Sub-account. Holder has no legal, equitable, direct, or indirect interest in any of the assets held by a Sub-account. Rather, Holder has only a contractual claim against IC to collect cash from IC in the form of death benefits, or cash surrender values under the Contract.

All decisions concerning the choice of Advisor or the choice of any of IC=s investment officers that are involved in the investment activities of Separate Account or any of the Sub-accounts, and any subsequent changes thereof, are made by IC in its sole and absolute discretion. Holder may not communicate directly or indirectly with IC concerning the selection or substitution of Advisor or the choice of any IC=s investment officers that are involved in the investment activities of Separate Account or any of the Sub-accounts.

Situation 2: The facts are the same as Situation 1 except that Holder purchases an annuity Contract ("Annuity").

LAW

Section 61(a) provides that the term "gross income" means all income from whatever source derived, including gains derived from dealings in property, interest and dividends.

A long standing doctrine of taxation provides that Ataxation is not so much concerned with the refinements of title as it is with actual command over the property taxed--the actual benefit for which the tax is paid.@ Corliss v. Bowers, 281 U.S. 376 (1930). The incidence of taxation attributable to ownership of property is not shifted if the transferor continues to retain significant control over the property transferred, Frank Lyon Company v. United States, 435 U.S. 561 (1978); Commissioner v. Sunnen, 333 U.S. 591 (1948); Helvering v. Clifford, 309 U.S. 331 (1940), without regard to whether such control is exercised through specific retention of legal title, the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. Christoffersen v. U.S., 749 F.2d 513 (8th Cir.), rev=g 578 F. Supp. 398 (N.D. Iowa 1984).

Rev. Rul. 77-85, 1977-1 C.B. 12, considers a situation in which the individual purchaser of a variable annuity contract retained the right to direct the custodian of the account supporting that variable annuity to sell, purchase, and exchange securities or other assets held in the custodial account. The purchaser also was able to exercise an owner=s right to vote account securities either through the custodian or individually. The Service concluded that the purchaser possessed Asignificant incidents of ownership@ over the assets held in the custodial account. The Service reasoned that if a purchaser of an "investment annuity" contract may select and control the investment assets in the separate account of the life insurance company issuing the contract, then the purchaser is treated as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets are included in the purchaser=s gross income.

In Rev. Rul. 80-274, 1980-2 C.B. 27, the Service, applying Rev. Rul. 77-85, concludes that, if a purchaser of an annuity contract may select and control the certificates of deposit supporting the contract, then the purchaser is considered the owner of the certificates of deposit for federal income tax purposes. Similarly, Rev. Rul. 81-225, 1981-2 C.B. 12, concludes that investments in mutual fund shares to fund annuity contracts are considered to be owned by the purchaser of the annuity if the mutual fund shares are available for purchase by the general public. Rev. Rul. 81-225 also concludes that, if the mutual fund shares are available only through the purchase of an annuity contract, then the sole function of the fund is to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its annuity contracts and the mutual fund shares are considered to be owned by the insurance company. Finally, in Rev. Rul. 82-54, 1982-1 C.B. 11, the purchaser of certain annuity contracts could allocate premium payments among three funds and had an unlimited right to reallocate contract value among the funds prior to the maturity date of the annuity contract. Interests in the funds were not available for purchase by the general public, but were instead only available through purchase of an annuity contract. The Service concludes that the purchaser=s ability to choose among general investment strategies (for example, between stock, bonds, or money market instruments) either at the time of the initial purchase or subsequent thereto, does not constitute control sufficient to cause the contract holders to be treated as the owners of the mutual fund shares.

In Christoffersen v. U.S., the Eighth Circuit considered the federal income tax consequences of the ownership of the assets supporting a segregated asset account. The taxpayers in Christoffersen purchased a variable annuity contract that reflected the investment return and market value of assets held in an account that was segregated from the general asset account of the issuing insurance company. The taxpayers had the right to direct that their premium payments be invested in any one of six publicly traded mutual funds. The taxpayers could reallocate their investment among the funds at any time. The taxpayers also had the right upon seven days notice to withdraw funds, surrender the contract, or apply the accumulated value under the contract to provide annuity payments.

The Eighth Circuit held that, for federal income tax purposes, the taxpayers, not the issuing insurance company, owned the mutual fund shares that funded the variable annuity. The court concluded that the taxpayers Asurrendered few of the rights of ownership or control over the assets of the sub-account," that supported the annuity contract. Christoffersen, 749 F.2d at 515. According to the court, Athe payment of annuity premiums, management fees and the limitation of withdrawals to cash [did] not reflect a lack of ownership or control as the same requirements could be placed on traditional brokerage or management accounts.@ Id. at 515-16. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

Section 817, which was enacted by Congress as part of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) (the "1984 Act"), provides rules regarding the tax treatment of variable life insurance and annuity contracts. Section 817(d) defines a Avariable contract@ as a contract that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to State law or regulation, is segregated from the general asset accounts of the company and that provides for the payment of annuities, or is a life insurance contract. In the legislative history of the 1984 Act, Congress expressed its intent to deny life insurance treatment to any variable contract if the assets supporting the contract include funds publicly available to investors:

> The conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. . . . In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . .

H.R. Conf. Rep. No. 98-861, at 1055 (1984).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.

Approximately two years after enactment of ' 817(h), the Treasury Department issued proposed and temporary regulations prescribing the minimum level of diversification that must be met for an annuity or life insurance contract to be treated as a variable contract within the meaning of ' 817(d). The preamble to the regulations stated as follows:

> The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the definition of variable contracts.

51 FR 32633 (Sept. 15, 1986). The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. See 51 FR 32664 (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

ANALYSIS

The determination of whether Holder possesses sufficient incidents of ownership over Sub-account assets to be deemed the owner of the assets supporting LIC and Annuity depends on all of the relevant facts and circumstances.

Holder may not select or direct a particular investment to be made by either the Separate Account or the Sub-accounts. Holder may not sell, purchase, or exchange assets held in the Separate Account or the Sub-accounts. All investment decisions concerning the Separate Account and the Sub-accounts are made by IC or Advisor in their sole and absolute discretion.

The investment strategies of the Sub-accounts currently available are sufficiently broad to prevent Holder from making particular investment decisions through investment in a Sub-account. Only IC may add or substitute Sub-accounts or investment strategies in the future. No arrangement, plan, contract, or agreement exists between Holder and IC or between Holder and Advisor regarding the specific investments or investment objective of the Sub-accounts. In addition, Holder may not communicate directly or indirectly with Advisor or any of IC=s investment officers concerning the selection, quality, or rate of return of any specific investment or group of investments held by Separate Account or in a Sub-account.

Investment in the Sub-accounts is available solely through the purchase of a Contract, thus, Sub-accounts are not publicly available. The ability to allocate premiums and transfer funds among Sub-accounts alone does not indicate that Holder has control over either Separate Account or Sub-account assets sufficient to be treated as the owner of those assets for federal income tax purposes.

Based on all the facts and circumstances, Holder does not have direct or indirect control over the Separate Account or any Sub-account asset. Therefore, Holder does not possess sufficient incidents of ownership over the assets supporting either LIC or Annuity to be deemed the owner of the assets for federal income tax purposes. So long as LIC and Annuity continue to satisfy the diversification requirements of ' 817(h) and IC's and Holder's future conduct is consistent with the facts of this ruling, Holder will not be required to include the earnings on the assets held in Separate Account or any of the Sub-accounts in income under ' 61(a).

HOLDING

Under the facts set forth above, the holder of a variable contract will not be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract. Therefore, any interest, dividends, or other income derived from the assets that fund the variable contract is not included in the holder's gross income in the year in which the interest, dividends, or other income is earned.

DRAFTING INFORMATION

The principal author of this revenue ruling is James Polfer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Mr. Polfer at (202) 622-3970 (not a toll-free call).

Part I

Section 61. B Gross Income Defined

26 CFR 1.61-1: Gross Income
(Also ' ' 801, 817, 7702; 1.817-5)

Rev. Rul. 2003-92

ISSUES

Under the facts set forth below, will the holder of a variable annuity or life insurance contract be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public? What are the income tax consequences to the holder of the contract if that holder is considered to be the owner of the partnership interests that fund the variable contract?

FACTS

Situation 1. IC is a life insurance company subject to tax under ' 801 of the Internal Revenue Code. In states where it is authorized to do so, IC offers deferred variable annuity contracts. IC has developed a variable annuity contract (AAnnuity@) for sale only to Aqualified purchasers@[1] that are Aaccredited investors@[2] or to no more than one hundred accredited investors. IC is not required to register Annuity under the federal security laws.

Contract Holder, an individual qualifying as both a qualified purchaser and an accredited investor, purchases Annuity from IC. Annuity contains a number of provisions common to deferred annuity contracts, including the right of Contract Holder to surrender Annuity in part or entirely for cash (subject to a surrender charge) and the right to convert (at

---

[1] Under 15 U.S.C. ' 80a-2(a)(51) a Aqualified purchaser" is an individual, or other specified entity, that satisfies certain threshold financial requirements.

[2] The term Aaccredited investor,@ as defined by 15 U.S.C. ' 77b(a)(15), and amplified by 17 CFR ' 230.501(a), is also an investor that satisfies certain financial criteria. An accredited investor may be either an individual or certain enumerated entities. Because the criteria to be an accredited investor are similar to, but not identical to, the criteria that must be met to be a qualified purchaser it is possible for an accredited investor to also be a qualified purchaser. It is also possible for an investor to qualify only as either an accredited or qualified investor.

future dates chosen by Contract Holder) the accumulated values under Annuity into a stream of periodic payments under one of several settlement options.

The assets supporting Annuity are held in a segregated asset account that is maintained separately from IC=s other accounts. The segregated asset account is divided into 10 sub-accounts (ASub-accounts@). Each Sub-account=s assets and liabilities are maintained separately from the assets and liabilities of other Sub-accounts. At the time of purchase, Contract Holder specifies the premium allocation among the available Sub-accounts. Contract Holder may change the allocation of subsequent premiums at any time.

Each Sub-account available under Annuity invests in interests in a partnership (APartnership@). None of the Partnerships are publicly traded partnerships under ' 7704. All of the Partnerships are exempt from registration under federal security laws. Interests in each Partnership are sold in private placement offerings and are sold only to qualified purchasers that are accredited investors or to no more than one hundred accredited investors.

Each Partnership has an investment manager that selects the Partnership=s specific investments. Contract Holder may not act as an investment manager or independently own any interest in any Partnership offered under Annuity. In addition, Contract Holder will have no voting rights with respect to any Partnership interest held by any Sub-account.

Each Sub-account will at all times meet the asset diversification test set forth in ' 1.817-5(b)(1) of the Income Tax Regulations.

Situation 2. The facts are the same as those in Situation 1, except IC offers, and Contract Holder purchases, a variable life insurance contract (ALIC@) that qualifies as a life insurance contract under ' 7702.

Situation 3. The facts are the same as those in Situation 1, except that (i) Contract Holder purchases both an Annuity and an LIC and (ii) interests in each Partnership are available for purchase only through the purchase of an Annuity, an LIC, or other variable contracts from insurance companies.

LAW

Section 61(a) provides that the term "gross income" means all income from whatever source derived, including gains derived from dealings in property, interest, and dividends.

Section 817, which was enacted by Congress as part of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) (the “1984 Act”), provides rules regarding the tax treatment of variable life insurance and annuity contracts. Section 817(d) defines a Avariable contract@ as a contract that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to State law or regulation, is segregated from the general asset accounts of the company and that provides for the payment of annuities, or is a life insurance contract. In the legislative history of the 1984 Act Congress expressed its intent to deny life insurance treatment to any variable contract if the assets supporting the contract include funds publicly available to investors:

> The conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. . . . In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . .

H.R. Conf. Rep. No. 98-861, at 1055 (1984).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.

Approximately two years after enactment of ' 817(h), the Treasury Department issued proposed and temporary regulations prescribing the minimum level of diversification that must be met for an annuity or life insurance contract to be treated as a variable contract within the meaning of ' 817(d). The preamble to the regulations stated as follows:

> The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the definition of variable contracts.

51 FR 32633 (Sept. 15, 1986). The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. <u>See</u> 51 FR 32664 (Sept. 15,

1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

Prior to enactment of § 817, the Service issued a number of revenue rulings regarding when the owner of an annuity contract will be treated as the owner of the assets that fund the annuity. In the revenue rulings, the Service relied on long standing tax principles. See generally, Commissioner v. Sunnen, 333 U.S. 591 (1948); Helvering v. Clifford, 309 U.S. 331 (1940); Corliss v. Bowers, 281 U.S. 376 (1930). The revenue rulings consider whether the contract owners described in each ruling have retained sufficient incidents of ownership, as described in cases cited above, over the assets or retain sufficient control over the assets to be treated as the owners of those assets.

Rev. Rul. 77-85, 1977-1 C.B. 12, concludes that if a purchaser of an "investment annuity" contract selects and controls the investment assets in the separate account of the issuing life insurance company, then the purchaser will be treated as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets are includible in the gross income of the purchaser. Similarly, Rev. Rul. 80-274, 1980-2 C.B. 27, holds that if a purchaser of an annuity contract may select and control the certificates of deposit supporting the contract, then the purchaser is treated as the owner of the certificates of deposit for federal income tax purposes. In Rev. Rul. 80-274, the insurance company could not dispose of the deposit or convert it into a different asset. The insurance company did, however, have the power to withdraw the deposit from a failing savings and loan association.

Rev. Rul. 81-225, 1981-2 C.B. 12, describes four situations in which investments in mutual fund shares to fund annuity contracts are treated as owned by the policyholder rather than by the issuing insurance company, and one situation in which the issuing insurance company is treated as the owner of the mutual fund shares. In Situation 1, the investment assets in the segregated account supporting the annuity contracts consisted solely of shares in a single, publicly available mutual fund managed by an independent investment advisor. Situation 2 is similar to Situation 1, except that the publicly available mutual fund was managed by the issuing insurance company or one of its affiliates. Situation 3 also is similar to Situation 1, except that the segregated asset account supporting the annuity contracts consisted of five sub-accounts. Each sub-account was invested in the shares of a different mutual fund. Shares of the mutual funds were offered for sale to the general public. The policyholder retained the right to allocate or reallocate funds among the five sub-accounts during the life of the annuity contract. Situation 4 is similar to Situation 2, except that the mutual fund did not sell shares directly to the public. The shares of the mutual fund were available only through the purchase of an annuity contract or by participation in an investment plan account of the type described in Rev. Rul. 70-525, 1970-2 C.B. 144. Situation 5 also was similar to Situation 2, except that the shares in the mutual fund were available only through the purchase of an annuity contract.

Rev. Rul. 81-225 concludes that the policyholders in Situations 1 through 4 had sufficient control and other incidents of ownership to be treated as the owners of the mutual fund shares for federal income tax purposes. The ruling reaches the opposite conclusion in Situation 5, because the sole function of the mutual fund in Situation 5 was to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its annuity contracts and the insurance company possessed sufficient incidents of ownership to be treated as the owner of the underlying portfolio of assets of the mutual fund for federal income tax purposes.

In Rev. Rul. 82-54, 1982-1 C.B. 11, the purchasers of certain annuity contracts could direct the issuing insurance company to invest in the shares of any one or any combination of three mutual funds that were not available to the public. One mutual fund invested primarily in common stocks, another in bonds, and the third in money market investments. Policyholders could allocate their premium payments among the three funds and had an unlimited right to reallocate contract values among the funds prior to the maturity date of the annuity contract. The ruling concludes that the policyholders' ability to choose among general investment strategies (for example, between stock, bonds, or money market funds) either at the time of the initial purchase or subsequent thereto, did not constitute control sufficient to cause the policyholders to be treated as the owners of the mutual fund shares.

In Christoffersen v. United States, 749 F.2d 513 (8th Cir.), rev=g 578 F. Supp. 398 (N.D. Iowa 1984), the Eighth Circuit considered the federal income tax ownership of the assets supporting a segregated asset account. The taxpayers in Christoffersen purchased a variable annuity contract that reflected the investment return and market value of assets held in an account that was segregated from the general asset account of the issuing insurance company. The taxpayers had the right to direct that their premium payments be invested in any one or a combination of six publicly traded mutual funds. The taxpayers could reallocate their investment among the funds at any time. The taxpayers also had the right upon seven days notice to withdraw funds, surrender the contract, or apply the accumulated value under the contract to provide annuity payments.

The Eighth Circuit held that, for federal income tax purposes, the taxpayers, not the issuing insurance company, owned the mutual fund shares that funded the variable annuity. The court concluded that the taxpayers Asurrender few of the rights of ownership or control over the assets of the sub-account@ that supported the annuity contract. Christoffersen, 749 F.2d at 515. According to the court, Athe payment of annuity premiums, management fees and the limitation of withdrawals to cash [did] not reflect the lack of ownership or control as the same requirements could be placed on traditional brokerage or management accounts.@ Id. at 515-16. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

ANALYSIS

In Situation 1, Sub-accounts hold interests in Partnerships available for purchase other than by purchasers of Annuity or other variable contracts from insurance companies. Therefore, for federal income tax purposes, Contract Holder is the owner of the interests in Partnerships held by Sub-accounts. As a result, pursuant to ' 61(a), Contract Holder must include in its gross income any interest, dividends, or other income derived from the interests in the Partnerships in the year in which the interest, dividends, or other income is earned.

In Situation 2, Sub-accounts hold interests in Partnerships available for purchase other than by purchasers of LIC or other variable contracts from insurance companies. Therefore, for federal income tax purposes, Contract Holder is the owner of the interests in Partnerships held by Sub-accounts. As a result, pursuant to ' 61(a), Contract Holder must include any interest, dividends, or other income derived from the Partnerships in gross income in the year in which the interest, dividends, or other income is earned.

In Situation 3, Sub-accounts hold interests in Partnerships available for purchase only by a purchaser of an Annuity, a LIC, or other variable contracts from insurance companies. Therefore, for federal income tax purposes, IC owns the interests in Partnerships that fund the Sub-accounts. As a result, pursuant to ' 61(a), any interest, dividends, or other income derived from the Partnerships is not included in Contract Holder=s gross income in the year in which the interest, dividends, or other income is earned.

HOLDINGS

Under the facts set forth above, the holder of a variable annuity or life insurance contract will be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public. If the holder of a variable annuity or life insurance contract is considered to be the owner of the partnership interests that fund the variable contract, pursuant to ' 61(a), the contract holder must include any interest, dividends, or other income derived from the partnership interests in gross income in the year in which the interest, dividends, or other income is earned.

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 81-225, 1981-2 C.B. 12 is hereby clarified and amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is James Polfer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Mr. Polfer at (202) 622-3970 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 23, 2003
JS-592

President's Commission on United States Postal Service
Holds Final Public Meeting
Commission Considered Draft Final Report to President

The President's Commission on the United States Postal Service today received and considered the recommendations of its Workforce subcommittee and Technology Challenges and Opportunities subcommittee at its ninth and final public meeting. The Commission also considered a draft final report to the President. Under Executive Order 13278, the Commission's final report must be transmitted to the President on or before July 31, 2003.

The adopted recommendations are attached below.

The nine-member bipartisan Commission, established by President Bush on December 11, 2002, will identify the operational, structural, and financial challenges facing the Postal Service; examine potential solutions; and recommend legislative and administrative steps to ensure the long-term viability of postal services in the United States. The Commission is co-chaired by James A. Johnson, Vice Chairman of Perseus, L.L.C., and Harry J. Pearce, Chairman of Hughes Electronics Corporation.

Additional information about the Commission can be found at http://www.treasury.gov/offices/domestic-finance/usps

Related Documents:

- recommendations
- recommendations

Report of the Technology Subcommittee
Final Recommendations to the Commission

The Technology Subcommittee submits the following recommendations to the Commission:

1. ***Automation Technology.*** *The Subcommittee recommends that the Postal Service balance capital expenditures on new automation technology with consideration of outsourcing elements of the processing network. The Postal Service should neither acquire excess capacity that would only be used during peak periods nor undertake functions that the private sector could perform more effectively and at less cost than the Postal Service itself. Nonetheless, the Subcommittee acknowledges the steps the Postal Service has taken to automate its system for processing single-piece letter mail and welcomes the progress made in the automation of the processing of flats and packages. The Subcommittee recommends the continued development of an effective merging system that is responsive to customer needs and culminates in one bundle of mixed letters and flats for each delivery point.*

2. ***Processing Standardization.*** *The Subcommittee recommends that the Postal Service study the problem of mail processing with the possible goal of redesign of the whole mail system, using the latest in 21st century technology. The Subcommittee further recommends that the Postal Service examine every one of its "legacy systems" and question its purpose and whether it is needed. In addition, the Subcommittee recommends that mail processing redesign include a standard or common footprint for each processing facility, with an identical level of technology and machinery in each. This would allow easy shifting of personnel to manage the mail flow more efficiently. The Subcommittee views this redesign study as complementary to the Postal Service's current network rationalization initiative.*

3. ***Intelligent Mail.*** *The Subcommittee notes that the ability of the Postal Service to track individual pieces of mail can improve internal efficiency and satisfy postal customers that mail is delivered to the right location and on time. The Subcommittee recognizes that technology to achieve this goal exists today and is now being used by some of the competitors of the Postal Service. The Subcommittee recommends that the Postal Service work to put mail tracking technology in place on a timely and more comprehensive basis, so that it is available to all users, large and small, at an affordable price.*

4. ***The Transportation Network.*** *The Subcommittee recommends that the Postal Service integrate its facility automation efforts with its transportation network by using Intelligent Mail technology, GPS, and onboard computer technology. The Subcommittee also recommends that the Postal Service put in place a cost-effective system capable of tracking every vehicle on its route and allowing each vehicle to communicate in real time, either by voice or electronic communication, with appropriate fixed facilities.*

5. ***Improved USPS Website and Personalized Stamps.*** *The Subcommittee recommends that postal services available at Post Offices should also be generally available on the USPS website and at Postal Service kiosks and contract stations at reasonable prices for all postal customers, from the individual to the large mailer. The Subcommittee recommends the development and production of "personalized" stamps that are made available through appropriate sources, beginning with the USPS website. These stamps should be offered to postal customers at a reasonable premium.*

6. ***Security.*** *The Subcommittee believes that the events of 9/11 and the Postal Service anthrax incidents have increased the need to ensure security in the mail system. The Subcommittee believes that a more secure system could be built using sender identified mail. The Subcommittee recommends that the Postal Service, in coordination with the Department of Homeland Security, explore the use of sender identification for every piece of mail, commercial and retail.*

7. ***Evaluation, Acquisition and Deployment of Technology.*** *The Subcommittee acknowledges that the Postal Service recently created the new Mailing Technology Strategy Council to provide assessments of technology trends. It recommends that the Council be strengthened to be an independent advisory body empowered to do more than provide assessments. The Subcommittee believes the Council should not only originate ideas for improving the mail system, but should accept them from all sources, including the individual Postal Service user. It should study, evaluate and recommend to the Postmaster General technologies that could be used to upgrade the mail system. The Subcommittee recommends that the Postal Service management provide an annual report to the Board of Directors on the work of the Mailing Technology Strategy Council.*

Report of the Workforce Subcommittee
Final Recommendations to the Commission

The Workforce Subcommittee submits the following recommendations to the Commission:

1. ***Developing an Appropriately-Sized Workforce****. As the Postal Service works to meet the challenges of the 21st century, it must develop a world-class workforce appropriate to fulfilling its universal service obligation. Fortunately, the Postal Service will soon be presented with a unique attrition opportunity with some 47% of current career employees eligible for retirement by 2010. The Subcommittee urges the Postal Service to take full advantage of this attrition opportunity and to exercise maximum discipline in its hiring practices in order to right-size and realign its workforce with minimal displacement.*

2. ***Collective Bargaining: Process Improvements****. The Subcommittee affirms the collective bargaining process and recommends that it be retained. However, the Subcommittee believes that the collective bargaining process can be improved to create additional incentives for the parties to reach negotiated settlements, and, when the parties fail to reach a negotiated settlement, to ensure that arbitration awards are made within a reasonable period of time. In particular, the Subcommittee recommends the following:*

    - <u>*Basic process*</u>*. A negotiation process, beginning 90 days prior to the expiration of an existing agreement, followed by a 30-day mandatory mediation process and, if mediation fails, an immediate 60-day interest arbitration process.*

    - <u>*Mandatory mediation and "Med-Arb*</u>*." The 30-day mandatory mediation process would be conducted by a mediator who would become a member of the arbitration panel should mediation fail. The purpose of the mediation process would be to either reach a negotiated settlement or to narrow the range of issues to be submitted to interest arbitration.*

    - <u>*Interest arbitration*</u>*. The 60-day interest arbitration process would be conducted by a three-person arbitration panel comprised of three neutral arbitrators, one having served as the mediator. The interest arbitration process would incorporate the Last Best Final Offer ("LBFO") mechanism, and a 10-day period during which the parties would have a final opportunity to reach a negotiated settlement prior to the arbitration panel's final award.*

3. ***Collective Bargaining: New Subjects.*** *The Subcommittee believes that the Postal Service's pension and post-retirement health care plans should be subject to collective bargaining – meaning that the Postal Service and its unions should have the flexibility to develop new plans that are separate and apart from existing Federal pension and retiree health care plans. However, the Subcommittee is also concerned about the uncertain impact such a change would have on the Federal system as a whole and on other Federal employees in particular. As a consequence, the Subcommittee recommends that the Postal Service work with the Department of the Treasury, the Office of Personnel Management, and any other persons or entities deemed necessary to determine the impact separate Postal Service pension and retiree health care programs would have on the existing Federal systems. As a first step, the Subcommittee recommends that:*

- *The Postal Service be authorized to negotiate Federal Employee Retirement System ("FERS") eligibility requirements and employee contributions;*

- *The Postal Service be authorized to negotiate the eligibility and retiree contribution requirements for the post-retirement health care component of the Federal Employee Health Benefit Program ("FEHBP"), specifically for future Postal Service retirees; and*

- *The current statutory requirement that "[n]o variation, addition, or substitution with respect to fringe benefits shall result in a program of fringe benefits which on the whole is less favorable to the officers and employees than fringe benefits in effect on [July 1, 1971]" be repealed.*

4. ***Pay Comparability.*** *The Subcommittee recommends that the 1970 Act be amended to clarify the meaning of the term comparability, and that the new Postal Regulatory Board be authorized to determine comparable total compensation for all Postal Service employees. In determining comparable total compensation, the Subcommittee recommends that the Postal Regulatory Board be authorized to determine the appropriate sector(s) of the private sector workforce to be used as the basis of comparison. The comparability determination of the Postal Regulatory Board should be enforced as a cap on the total compensation of new employees. In addition, if the Postal Regulatory Board determines that a total compensation premium exists for current employees, the Subcommittee recommends that it be authorized to determine the appropriate period of time during which the premium must be eliminated, and to review periodically its initial determination and the Postal Service's progress in eliminating the premium.*

5. ***Pay-for-Performance***. *The Subcommittee believes strongly that performance-based compensation programs are effective tools that, when designed correctly, can be used to align the goals of management and labor and result in improved efficiency and service quality. The Subcommittee, therefore, recommends that the Postal Service undertake a careful study of performance-based compensation programs for both management and represented employees, and that it work with the unions and management associations to design and implement a performance-based compensation program that is meaningful to Postal Service employees and assists the Postal Service in meeting its productivity and service quality goals.*

6. ***Grievances***. *The Subcommittee believes that the current dispute resolution process must be revised if the Postal Service is to operate in accordance with the best practices of private sector companies with highly unionized workforces. As a first step, the Subcommittee recommends that the Postal Service work diligently with its unions to implement best practice grievance procedures, including those recently implemented by the Postal Service and the National Association of Letter Carriers.*

7. ***Workers' Compensation Claims***. *The Subcommittee recommends that the Postal Service be provided relief from certain requirements of the Federal Employees' Compensation Act (FECA). Specifically, the Subcommittee recommends the following:*

   - *The Postal Service should not be required to pay benefits until after the expiration of a three-day waiting period;*

   - *The Postal Service should be allowed to limit benefits to 2/3 of the maximum weekly rate; and*

   - *The Postal Service should be allowed to transition individuals receiving workers' compensation to the Postal Service's retirement plan at such time as the employee would have become eligible for retirement notwithstanding the injury giving rise to the workers compensation benefits.*

8. ***Executive Compensation***. *The Subcommittee recommends that the current statutory salary cap be repealed. The Subcommittee further recommends that the Board of Directors be authorized to establish rates of pay for officers and employees at levels competitive with the private sector, and that performance be considered by the new Board of Directors as a key component of the pay for senior executives.*

9. ***Management Structure**. The Subcommittee recommends that the Postal Service restructure its management to eliminate redundant positions and geographical divisions and standardize and clarify job functions. The Subcommittee also recommends that the new Board of Directors conduct a review of the entire management structure, size and cost to determine whether they are necessary and consistent with the best practices of the private sector and to require managers to justify their functions and the size of their staffs.*

10. ***Accounting for Retiree Health Care Obligations**. The Subcommittee recommends that the new Board of Directors review the current Postal Service policy relating to the accounting treatment of retiree health care benefits, and work with the Postal Service's independent auditor to determine the most appropriate treatment of such costs in accordance with applicable accounting standards and in consideration of the Postal Service's need for complete transparency in the reporting of future liabilities. The Subcommittee also recommends that the Postal Service Board of Directors consider funding a reserve account for unfunded retiree health care obligations to the extent that the Postal Service's financial condition allows.*

11. ***Funding Military Service**. The Subcommittee recommends that responsibility for funding CSRS pension benefits relating to the military service of Postal Service retirees be returned to the Department of the Treasury.*

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 23, 2003
JS-593

Bush Economic Team Announces Trip to Wisconsin, Minnesota to Discuss the President's Efforts to Strengthen the Economy and Create Jobs

Treasury Secretary John Snow, Commerce Secretary Don Evans and Labor Secretary Elaine L. Chao will travel to Wisconsin and Minnesota on Tuesday, July 29th and Wednesday, July 30th to discuss the state of the economy and the recently enacted jobs and growth plan - as well as other efforts by President Bush to create jobs, strengthen the economic recovery and increase workers' standards of living.

During the "Jobs and Growth Tour" Secretaries Snow, Evans and Chao will participate in town hall style meetings, roundtables, and tours in the two states, and will meet with families, workers, manufacturers, local business leaders, economic officials, small business owners, seniors and individual investors.

President Bush believes that everyone should have the opportunity to get a job who wants a job. The most effective support we can provide for American workers is long-term economic growth. That is why President Bush and his economic team worked hard with the Congress to enact the Jobs and Growth Act - the main elements of which are just beginning to take effect.

More than 1.7 million taxpayers in Minnesota, and another 1.8 million taxpayers in Wisconsin, will have lower income tax bills in 2003 as a result of President Bush's Jobs and Growth Act.

A schedule of the tour will be released at a later time.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 23, 2003
JS-594

Treasury and IRS Issue Guidance on Forward Contract/Note Units

Today the Treasury Department and the Internal Revenue Service issued guidance in the form of a Revenue Ruling regarding a financial product consisting of a forward contract and note that is issued as a single unit. The guidance addresses the question of whether the interest on the note is deductible for tax purposes. The Revenue Ruling clarifies that interest is deductible, but only under specified circumstances. The Revenue Ruling also requests comments whether regulations should be issued under 163(l) to address the policy issues raised by this product.

Related Documents:

- The text of Revenue Ruling 2003-97

•

Part I

Section 163.--Interest

26 CFR 1.163-1: Interest deduction in general.
(Also § 7805(b)(8); 301.7805-1.)

Rev. Rul. 2003-97

ISSUE

Under the facts presented below, if a corporation issues units, each consisting of instruments in the form of a 5–year note and a 3–year forward contract to purchase a quantity of the corporation's common stock, is the "interest" accruing on the note deductible under § 163(a) of the Internal Revenue Code and not disallowed under § 163(*l*)?

FACTS

On August 18, 2003 ("Issue Date"), X, a corporation, issues units, each consisting of instruments in the form of a 3–year forward contract to purchase a quantity of X's common stock ("Purchase Contract") and a 5–year note issued by X ("Note") (together, a "Purchase-Contract/Note unit"). The Purchase Contract requires the holder to purchase, and X to sell, on August 18, 2006 ("Settlement Date"), a quantity of X's common stock that is determined by reference to the market price of the stock on the Settlement Date. The Note has a stated maturity date of August 18, 2008 ("Maturity Date").

Under the Purchase Contract, on the Settlement Date the holder must pay an amount ("Settlement Price") that is equal to the stated principal amount of the Note. If the market price of X's common stock on the Settlement Date falls within a specific range of market prices (bounded by a "lower limit" based on the market price on the Issue Date and an "upper limit" equal to approximately 120 percent of the lower limit), the quantity of stock deliverable under the Purchase Contract will have a market value equal to the Settlement Price. If the market price on the Settlement Date is less than the lower limit or greater than the upper limit, the quantity of stock that is deliverable under the Purchase Contract is the quantity that would be deliverable if the market price on that date were equal to the lower limit or the upper limit, respectively.

X allocates the purchase price of a Purchase-Contract/Note unit between the Purchase Contract and the Note according to their respective fair market values, as if the Purchase Contract and the Note were separate instruments. The amount allocated to the Note is equal to the Note's stated principal amount.

The Note contained in a Purchase-Contract/Note unit is pledged to secure the holder's obligation to pay the Settlement Price under the Purchase Contract. As described below, the holder, however, has the legal right to separate the Note from the Purchase-Contract/Note unit in either of two ways (producing a "Separated Note"). The holder is not economically compelled to keep a unit unseparated.

The holder may separate the Note from the Purchase-Contract/Note unit before the Settlement Date without paying the Settlement Price. To do so, the holder must transfer the unit to X's agent ("Purchase Contract Agent") together with a specific zero-coupon Treasury security ("Strip"), and then the holder will receive a "Purchase-Contract/Strip unit" together with the Separated Note (a "conversion"). The Strip contained in the Purchase-Contract/Strip unit replaces the Note as collateral. Once a holder has effected a conversion, the holder may transfer the Note and retain the Purchase-Contract/Strip unit or transfer the Purchase-Contract/Strip unit and retain the Note. The Strips mature shortly before the Settlement Date and pay an amount equal to the Settlement Price. On the Settlement Date, X will apply the proceeds from the Strip contained in any Purchase-Contract/Strip unit to satisfy the holder's obligation to pay the Settlement Price under the associated Purchase Contract.

In addition, before the completion of a successful remarketing (described below), the holder of a Purchase-Contract/Note unit or a Purchase-Contract/Strip unit may transfer the unit to the Purchase Contract Agent together with cash in an amount equal to the Settlement Price and receive a quantity of shares of X's common stock together with the Separated Note or the Strip (a "settlement with separate cash").

The Note provides for quarterly payments of amounts denominated as interest, including a payment on the Settlement Date. This interest is payable at a single fixed rate ("Initial Rate"). The Notes are required to be remarketed on specific dates before the Settlement Date, including May 15, 2006, and August 15, 2006 ("Final Remarketing Date"). A successful remarketing of the Notes generally will result in the sale of the Notes to new holders effective on the next quarterly interest payment date (for example, May 18, 2006, and August 18, 2006) and will establish a new interest rate ("Reset Rate"), which will be effective after the remarketing for the remaining term of the Notes.

The Note is not subject to optional redemption by X at any time. Neither the written terms of the Note nor any other understanding or agreement requires the Note to be paid in, or converted into, X's stock. Similarly, neither the written terms of the Note nor any other understanding or agreement grants X an option to pay the Note in, or convert the Note into, X's stock.

X enters into a contract with an investment bank, Y, to serve as remarketing agent. Y will attempt to remarket the Notes with a Reset Rate that will permit the Notes to be sold for an amount equal to at least 100 percent of, and up to a target of 100½ percent of, a specific price ("Minimum Required Price"). There is no upper limit on the Reset Rate. For a remarketing on the Final Remarketing Date, the Minimum Required Price is the aggregate stated principal amount of the remarketed Notes. For remarketings before the Final Remarketing Date, the Minimum Required Price is the amount that could be invested in then-available zero-coupon Treasury securities ("Treasury Zeros") that mature shortly before the Settlement Date and pay an amount equal to the sum of the aggregate stated principal amount of the remarketed Notes, plus the aggregate interest at the Initial Rate that would have been payable on the Notes on the Settlement Date if the Notes had not been remarketed.

The remarketings will include all of the Notes contained in Purchase-Contract/Note units on the remarketing dates. In addition, holders of Separated Notes may elect to include those Notes in the remarketings. If a remarketing succeeds, the interest rate on all the Notes will be changed from the Initial Rate to the Reset Rate for the remaining term of the Notes, whether or not they were included in the remarketing.

A remarketing will not occur if a condition precedent to the remarketing (for example, the existence of an effective registration statement for the Notes) is not fulfilled. Moreover, even if all conditions are satisfied and a remarketing does occur, the remarketing will not succeed if Y is unable to obtain the Minimum Required Price. (In either case, the remarketing is said to "fail.") On the Issue Date, it is substantially certain that a remarketing of the Notes will succeed.

In the case of a Separated Note, if all of the remarketings fail, then, on the Settlement Date, the holder of the Note will have the right to put the Note to X in exchange for cash equal to the Note's stated principal amount plus any accrued but unpaid interest. If such a Note is not put to X, the Initial Rate will remain in effect for that Note until the Maturity Date.

In the case of a Note contained in a Purchase-Contract/Note unit, if all of the remarketings fail, X will exercise its rights as a secured party to dispose of the Notes in accordance with applicable law and satisfy in full the holder's obligation to purchase X's common stock under the Purchase Contract. As a result, the holder will receive the interest payment due on the Settlement Date and the amount of X's common stock deliverable under the Purchase Contract.

If a remarketing succeeds, the remarketing proceeds (or the proceeds of the Treasury Zeros in the case of a successful remarketing before the Final Remarketing Date) must be used by X in the following manner. If a Note was part of a Purchase-Contract/Note unit on the date of the successful remarketing, X must apply an amount equal to the stated principal amount of the Note to satisfy the former holder's obligation to pay the Settlement Price under the associated Purchase Contract.

In addition, X must pay the former holder cash in an amount equal to the interest (at the Initial Rate) that would have been payable to the holder on the Settlement Date had the Notes not been remarketed. If the successful remarketing occurs before the Final Remarketing Date, this amount will be paid out of the proceeds of the Treasury Zeros. If the successful remarketing occurs on the Final Remarketing Date, the amount will be paid out of X's own funds. X will make similar payments to the former holders of any participating Separated Notes.

Y will receive a remarketing fee of one quarter of one percent of the Minimum Required Price. This remarketing fee will be paid first from the excess, if any, of the remarketing proceeds over the Minimum Required Price and then, if necessary, by X from its own funds. If any proceeds in excess of the Minimum Required Price are not applied to the remarketing fee (that is, if the proceeds are between 100¼ percent and 100½ percent of the Minimum Required Price), these excess proceeds will be distributed to the former holders of the remarketed Notes (including any participating Separated Notes).

Purchase-Contract/Note units are listed on a national securities exchange. Purchase-Contract/Strip units and Separated Notes are not so listed but are freely assignable without restrictions on their transferability.

The Purchase Contract provides that, in the event of X's bankruptcy, the Purchase Contract will terminate and the associated Note or Strip will be released to the holder. On the Issue Date, X reasonably believes, based on advice from counsel, that this provision will be enforceable in bankruptcy and will result in the holder of a Purchase-Contract/Note unit being treated as a creditor in any bankruptcy proceeding.

Based on the terms of the Note and other facts and circumstances, if the Note were issued independently of the Purchase Contract in a transaction that did not link the rights and obligations under the Note with the rights and obligations under the Purchase Contract, then the Note would qualify as debt for federal income tax purposes, interest accruing on the Note would be deductible unless § 163(*l*) applies, and, under § 1.1001-3 of the Income Tax Regulations, the Note in existence before a successful remarketing would continue to exist after the remarketing. That is, the Note would not be treated as having been retired in conjunction with the issuance of a new debt instrument that bears an interest rate equal to the Reset Rate.

LAW AND ANALYSIS

As stated above, the Note would qualify as debt for federal income tax purposes if it were issued independently of the Purchase Contract in a transaction that did not link the rights and obligations under the Note with the rights and obligations under the Purchase Contract. Upon the earlier of a conversion, a settlement with separate cash, or a successful remarketing of the Note, the Note will no longer be linked with the Purchase Contract. At that time, the Note will qualify as debt for federal income tax purposes. Interest accruing on the Note after that time will be deductible under § 163(a).

On the other hand, during the time that the Note is contained in a Purchase-Contract/Note unit, there is an issue of whether the bundle of rights and obligations resulting from the unit should be treated for federal income tax purposes as consisting of a debt instrument and a stock purchase contract. An important initial inquiry bearing on whether the Note may be separately analyzed for federal income tax purposes is whether the Note is separable from the Purchase-Contract/Note unit. Even if the Note is separable, however, various features of the Note and Purchase Contract raise the possibility that, for federal income tax purposes, the Purchase-Contract/Note unit nevertheless is treated as some other combination of instruments. For example, a Purchase-Contract/Note unit could be treated as a prepaid forward contract to purchase a variable quantity of X's stock together with options (1) to acquire a Note by tendering a Strip to be combined into a Purchase-Contract/Strip unit or (2) to purchase a Note for cash by settling the forward contract early, together with a commitment by X to issue new Notes in the context of a "remarketing."

The correct characterization for federal income tax purposes of a transaction creating multiple rights and obligations depends on the facts and circumstances of the particular transaction. In deciding among multiple potential characterizations, the tax law seeks to find the best match between the bundle of rights and obligations and one or more categories of widely recognized instruments. In the instant case, the form chosen for the components of the unit reflects one reasonable division of the bundle of rights and obligations in the unit. Consequently, it is appropriate to begin the analysis of the issuer's tax consequences with respect to the unit by treating the unit as comprising these two components—namely, the Note and the Purchase Contract.

After the Note has been identified as one of the components of the Purchase-Contract/Note unit, determining whether X may deduct the amounts identified as interest on the Note contained in the Purchase-Contract/Note unit involves a multi-step analysis:

- Is the Note separable from the associated Purchase Contract?
- If the Note is separable from the Purchase Contract but is not in fact separated from the Purchase Contract, does the Note qualify as debt?
- If the Note qualifies as debt, does § 163(*l*) prevent X from deducting the interest that accrues on the Note?

Is the Note separable from the associated Purchase Contract?

Two factors are particularly important in analyzing whether the Note should be treated as separable from the Purchase Contract: whether the Purchase Contract and Note are separately transferable, and whether any factors (economic or otherwise) prevent the holder from effecting such a separate transfer.

Separate Transferability

Rev. Rul. 88–31, 1988–1 C.B. 302, holds that a share of common stock and a contingent payment right issued together as an investment unit are separate items of property for federal income tax purposes because they are separately tradable on a national securities exchange shortly after issuance. Similarly, in cases involving bond-warrant investment units in which the bond and warrant were separately tradable, several courts have stated in dicta that, because of the potential for separate trading, the bond and warrant were properly treated as separate instruments. See Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971); Hunt Foods and Industries, Inc. v. Commissioner, 57 T.C. 633 (1972). In contrast, when financial instruments cannot be separately traded, the courts have generally treated them as a single instrument. See Universal Castings Corp. v. Commissioner, 37 T.C. 107 (1961) (finding that a corporation's notes were "locked" to its stock by a shareholders' agreement so that neither the note nor the stock could be sold without the other, and therefore holding that the notes and stock constituted a "single investment" and the notes did not qualify as debt), aff'd, 303 F.2d 620 (7th Cir. 1962). Cf. De Coppet v. Commissioner, 38 B.T.A. 1381 (1938) (finding that an investment corporation's stock was "stapled" to a bank's stock through a trust arrangement so that neither could be sold without the other, and therefore holding that no part of the basis of the taxpayer's stapled stock could be recognized as a loss when the stock of the investment corporation became worthless), aff'd, 108 F.2d 787 (2d Cir.), cert. denied, 310 U.S. 646 (1940). These authorities indicate that, unless a holder has a legal right to separate linked instruments, they generally cannot be considered separable.

Economic Compulsion

The existence of a mere legal right to separate is insufficient for the Note and Purchase Contract to be considered separable. If the characterization of an instrument or a transaction for federal income tax purposes either depends on, or could be affected by, the existence of a person's legal right or option to elect a certain course of action, the tax consequences often depend on whether the exercise (or nonexercise) of the right or option is economically compelled based on all the facts and circumstances. See American Realty Trust v. United States, 498 F.2d 1194, 1199 (4th Cir. 1974) (upholding a verdict that a transaction was a good-faith sale and lease-back with a repurchase option, in part because the seller was not under "economic compulsion" to exercise the option); Roberts v. Commissioner, 71 T.C. 311, 323 (1978) (holding that a trust was not a mere conduit used by the taxpayer to obtain installment sale treatment under § 453 for a stock sale, in part because the trustees were under "no legal commitment or economic compulsion" to resell the stock when they did), aff'd, 643 F.2d 654 (9th Cir. 1981); Rev. Rul. 2003–7, 2003–5 I.R.B. 363 (holding that a collateralized forward contract to sell stock is not a current sale if the shareholder is not economically compelled to deliver the pledged shares); see also Comtel Corp. v. Commissioner, 45 T.C. 294, 307 (1965) (arrangement for stock purchase and subsequent sale of stock pursuant to an "option" was characterized as in substance a financing arrangement, in part because the Court concluded, after evaluation of the economic terms of the transaction, that taxpayer was "practically compelled" to exercise the option), aff'd, 376 F.2d 791, 796 (2d Cir.) (rejecting taxpayer's argument that it was not "economically compelled" to exercise the option), cert. denied, 389 U.S. 929 (1967); cf. Rev. Rul. 82–150, 1982–2 C.B. 110 (treating the holder of an option to purchase stock as the current owner because the holder paid 70 percent of the stock's value for the option and the strike price of the option was 30 percent of the stock's value).

For a Note to become separated from the Purchase-Contract/Note unit and transferable separately, one of three events must occur: (1) the holder effects a conversion, (2) the holder effects a settlement with separate cash, or (3) a successful remarketing occurs. If all of the remarketings fail, a Note in a Purchase-Contract/Note unit in effect will be exchanged on the Settlement Date for the X stock that is due to the holder under the Purchase Contract.

Notwithstanding these conditions and possibilities, however, under the facts stated in this ruling, the holder has the unrestricted legal right to separate the Note from the Purchase-Contract/Note unit and transfer the Note separately, and is not economically compelled to keep the unit unseparated. The need to take certain steps to effect a separation does not contradict the separateness that can ultimately be achieved. On the Issue Date, it is substantially certain that the remarketing will succeed; thus, the consequences of a hypothetical remarketing failure are not controlling. Accordingly, in light of all the facts and circumstances, when the Notes and Purchase Contracts were issued they were separable instruments.

If the Note is separable from the Purchase Contract but is not in fact separated from the Purchase Contract, does the Note qualify as debt?

Whether an instrument is debt for federal income tax purposes depends on the facts and circumstances of each case. No particular fact is conclusive in making such a determination. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). Among the factors considered by the courts are (1) whether there is an unconditional promise to pay a sum certain in money on a specific date, (2) the intent of the parties, and (3) the holder's right to enforce the payment of principal and interest. Bauer v. Commissioner, 748 F.2d 1365, 1368 (9th Cir. 1984); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972); Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957); Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973) ("Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?"), acq., 1974–2 C.B. 3.

In form, the transaction provides for investors to make an initial payment of money that will be repaid to the holder of a Note upon the maturity of the Note.

Although the Note is pledged as collateral for satisfaction of the separate Purchase Contract, the payment obligation under that contract is intended to be satisfied out of the proceeds of the remarketing of the Note. However, an initial holder is obligated in all events to acquire X's stock and will not itself receive the principal payment on the Note unless the holder takes action to separate the Note from the Purchase Contract.

A question is thus presented whether the amount paid by an initial holder should be characterized as the purchase price for the Note or as a prepayment on the Purchase Contract, with the actual Notes being issued by X only if and when there is a conversion, a settlement for separate cash, or a successful remarketing. An important consideration in answering this question is whether the issuance and acquisition of the units create debt characteristics.

On the one hand, in addition to the conditions necessary to cause a separation of the Note from the Purchase-Contract/Note unit as described above, the following factors suggest that the amount paid by a holder to acquire a unit could be treated simply as a prepayment of the Settlement Price under the Purchase Contract:

1. Ownership of a Purchase-Contract/Note unit exposes the holder to no risk of loss from a decline in the value of the Note because (i) if the Note is sold through a successful remarketing, the holder of a Purchase-Contract/Note unit is assured of having on the Settlement Date the amount necessary to satisfy the holder's obligation under the Purchase Contract; and (ii) if all remarketings fail, the holder of a Purchase-Contract/Note unit nevertheless receives the stock the acquisition of which is provided for under the Purchase Contract.

2. Ownership of a Purchase-Contract/Note unit provides the holder virtually no opportunity for gain from an increase in the value of the Note because the Initial Rate will be reset and the gain to be received from a remarketing is limited to 25 basis points.
3. Absent bankruptcy or the holder's decision to effect a conversion or a settlement with separate cash, the holder of a Purchase-Contract/Note unit will receive X's stock in all events under the Purchase Contract and will not receive any payments on the Note other than accrued interest and a distribution of excess proceeds in the event of a successful remarketing.
4. Upon a successful remarketing of the Note prior to the Final Remarketing Date, the holder will receive on the Settlement Date an amount equal to interest at the Initial Rate rather than the amount earned on the Treasury Zeros purchased with the proceeds from the remarketing.

On the other hand, the form in which the transaction is cast is a debt instrument, with a term that is substantially certain to last 5 years, with current interest payments, and with a remarketing that is to occur no later than 3 years after the Issue Date and that is not considered to be a reissuance under § 1001.

In addition, the Note has a critical debt characteristic even before the Note is separated from the Purchase Contract because the Purchase Contract provides that, in the event of X's bankruptcy, the Purchase Contract will terminate and the associated Note will be released to the holder; and on the Issue Date, X reasonably believes, based on the advice of counsel, that the provision will be enforceable in bankruptcy and will result in the holders being treated as creditors in the bankruptcy proceeding. The existence of these bankruptcy rights is an important debt characteristic. See P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 789–90 (3d Cir. 1962) (describing the right to share with general creditors in a corporation's assets in the event of dissolution or liquidation as "a most significant characteristic of the creditor-debtor relationship"); Nestlé Holdings, Inc. v. Commissioner, 94 T.C. 803, 813–14 (1990) (distinguishing mandatorily redeemable preferred stock from debt in part because preferred stockholders are always subordinate to creditors in liquidation).

In this context, the foregoing debt characteristics are sufficient to cause a Note included in a Purchase Contract/Note unit to be treated as debt for federal income tax purposes.

If the Note qualifies as debt, does § 163(*l*) prevent X from deducting the interest that accrues on the Note?

Section 163(*l*)(1) disallows a deduction for any interest paid or accrued on a "disqualified debt instrument." Section 163(*l*)(2) defines a "disqualified debt instrument" as indebtedness of a corporation that is payable in equity of the issuer or a related party. Section 163(*l*)(3) provides that indebtedness shall be treated as "payable in equity" of the issuer or a related party only if (A) a substantial amount of the principal or interest is required to be paid in or converted into, or at the option of the issuer or a related party is payable in or convertible into, such equity; (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity; or (C) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in (A) or (B). Section 163(*l*)(3) further provides that principal or interest shall be treated as required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised. The legislative history of § 163(*l*) states that an instrument is treated as payable in stock if it is part of an arrangement designed to result in payment with or by reference to such stock, including certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523–24 (1997), 1997–4 (Vol. 2) C.B. 1993–94.

All of the interest payments on all of the Notes will be made in cash. The principal payments on Separated Notes as well as Notes that have been sold in a remarketing will also be made in cash. Thus, if there is a successful remarketing, the principal payments on all of the Notes will be made in cash at the end of the 5–year term. If all of the remarketings fail, however, X's obligation to pay the stated principal amount of the Notes contained in the Purchase-Contract/Note units will be offset against the obligation of the holders to pay the Settlement Price on the Purchase Contracts. In that case, although the Note contained in a Purchase-Contract/Note unit technically will be applied in satisfaction of the holder's obligation to pay the Settlement Price rather than paid in stock, the holder will effectively receive X's stock in satisfaction of the stated principal amount of the Note. Thus, the Note may be considered to be "paid in" or "converted into" X's stock for purposes of § 163(*l*)(3).

Even without either a provision in the written terms of the Notes or any other understanding or agreement, in certain situations the facts and circumstances might support a conclusion that the issuance was part of an arrangement reasonably expected, in effect, to give X an option either to repay the Note with X's stock or to convert the Note into X's stock, or otherwise to result in such a repayment or conversion. For example, if X does not use its best efforts to make the remarketing succeed and all of the remarketings fail, the holder in effect will be compelled to receive X's stock in satisfaction of the stated principal amount of the Note.

In the instant transaction, however, several critical facts and contractual provisions support a contrary conclusion:

1. X has contracted to have the Notes remarketed and such an undertaking is subject to the requirements and sanctions of the Securities Act of 1933, 15 U.S.C. 77a–77aa (2000);
2. It is substantially certain that a remarketing of the Notes will succeed (in which case the Notes will remain outstanding until the Maturity Date and consequently will not be paid in, or converted into, X's stock);
3. The remarketing dates and the Maturity Date are such that the Notes will remain outstanding after the remarketing for a period that is significant both absolutely and relative to the total term of the Notes; and
4. On the Maturity Date, X will have an obligation to pay the principal amount of the Notes.

Thus, absent specific evidence of bad faith with respect to X's performance of its obligation to remarket the Notes, these critical facts and contractual provisions support the conclusion that the transaction is not reasonably expected to give X an option to pay the Notes in, or convert them into, X's stock, or to otherwise result in such a repayment or conversion .

Conclusion

The interest accruing on a Note contained in a Purchase-Contract/Note unit is deductible under § 163(a), and the deduction is not disallowed under § 163(*l*).

Four factors critical to this conclusion are:

Critical Factor I. The holder has the unrestricted legal right to convert the Purchase-Contract/Note unit into a Purchase-Contract/Strip unit or to settle the Purchase Contract with separate cash and retain the Note, and the holder is not economically compelled to keep the unit unseparated.

Critical Factor II. The Purchase Contract provides that, in the event of X's bankruptcy, the Purchase Contract will terminate and the associated Note or Strip will be released to the holder; and, on the Issue Date, X reasonably believes, based on advice from counsel, that the provision would be enforceable in bankruptcy and would result in the holder of a Purchase-Contract/Note unit being treated as a creditor in the bankruptcy proceeding.

Critical Factor III. The period the Notes will remain outstanding after a remarketing is significant, both absolutely and relative to the total term of the Notes. For purposes of this factor, Notes are considered to remain outstanding only during the period when they are not subject to redemption at the option of the issuer.

Critical Factor IV. On the Issue Date, it is substantially certain that a remarketing of the Notes will succeed. For purposes of this factor, a remarketing of the Notes is not substantially certain to succeed if the Reset Rate is capped.

HOLDING

Under the facts presented, the interest accruing on a Note contained in a Purchase-Contract/Note unit is deductible under § 163(a), and the deduction is not disallowed under § 163(*l*).

PROSPECTIVE APPLICATION

Under the authority of § 7805(b)(8), the holding of this revenue ruling will not be applied adversely with respect to a unit that was issued on or before August 22, 2003, provided that interest accruing on the unit would be deductible under this revenue ruling if—

(1) Critical Factor II required only that, under the transaction documents, in the event of the issuer's bankruptcy, the Purchase Contract will terminate and the associated Note or Treasury security will be released to the holder; and

(2) Critical Factor IV required only that the issuer of the unit undertook a legal obligation to attempt to cause a remarketing to succeed and reasonably believed that a remarketing would succeed.

REQUEST FOR COMMENTS

The Internal Revenue Service and the Treasury Department are considering whether to issue regulations under § 163(*l*) to address the policy issues raised by the transaction described in this ruling. The Internal Revenue Service and the Treasury Department request comments as to whether regulations should be promulgated and, if so, what these regulations should provide.

Comments should be submitted by October 22, 2003. Comments may be submitted to CC:PA:RU (Rev. Rul. 2003–97), room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8:00 a.m. and 4 p.m. Monday to Friday to CC:PA:RU (Rev. Rul. 2003–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, comments may be submitted via the Internet at Notice.Comments@irscounsel.treas.gov. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this revenue ruling is Charles Culmer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Mr. Culmer at (202) 622–3960 (not a toll–free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 24, 2003
JS-595

Introduction of the President by Secretary Snow Philadelphia, PA July 23, 2003

Good morning.

I am very pleased to be here at the Treasury Department's FMS facility on the eve of the printing and mailing of child tax credit checks to more than 25 million hardworking American families.

We are here today of course because of the remarkable leadership of President Bush, whose decisive action is helping us get the economy going again.

President Bush has urged each and every one of us on his economic team to keep working until every American who wants a job can get a job. Getting America back to work is the President's number one domestic priority, and it's an honor for me to assist him with that goal.

Now that the President' jobs and growth act is beginning to take affect, I am confident that we will be seeing more and more of those "help wanted" signs across America in the weeks and months ahead.

Ladies and gentlemen, the President of the United States, George W. Bush.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 24, 2003
JS-596

Child Tax Credit Advance Payment Checks Hit The Mail Tomorrow

Tomorrow, the first round of child tax credit advance payment checks will hit the mail. The checks are being sent out as a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003 which accelerates the child tax credit from $600 to $1,000 per child effective in 2003 and 2004.

"It's always exciting news to be able to tell people they will be getting more money. Over the next few weeks, millions of Americans and their families will be receiving their child credit checks. They will be able to use that money to save for their child's education, buy back-to-school clothes and school supplies, or use it to help make ends meet," stated Treasury Secretary John Snow. "Thanks to President Bush's leadership, millions of hardworking families will have more money to spend this summer."

This year, a typical family with one child will receive a check for $400. A typical family with two children will receive a check for $800. In all, approximately 25 million families will receive checks totaling $14 billion.

Checks are scheduled to be issued beginning July 25, 2003 in the following manner:

Last 2 Digits of SSN	Date Check Mailed from FMS	Estimated Volume	Estimated Dollars
00-33	7/25/03	8.6 million	$4.42 billion
34-66	8/1/03	8.4 million	$4.29 billion
67-99	8/8/03	8.4 million	$4.29 billion

The amount of advance payments will be based on taxpayers' 2002 filing status and income, as well as the number of children claimed on their 2002 tax return who will still be under age 17 in 2003.

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.
July 24, 2003

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $33,000 million to refund an estimated $30,657 million of publicly held 13-week and 26-week Treasury bills maturing July 31, 2003, and to raise new cash of approximately $2,343 million. Also maturing is an estimated $17,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced July 28, 2003.

The Federal Reserve System holds $13,849 million of the Treasury bills maturing on July 31, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held July 29, 2003. Amounts awarded to SOMA will be in addition to the offering amount.

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

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $1,155 million into the 13-week bill and $885 million into the 26-week bill.

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

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

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

oOo

Attachment

JS 597

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED JULY 31, 2003

July 24, 2003

Offering Amount	$16,000 million	$17,000 million
Maximum Award (35% of Offering Amount)	$ 5,600 million	$ 5,950 million
Maximum Recognized Bid at a Single Rate	$ 5,600 million	$ 5,950 million
NLP Reporting Threshold	$ 5,600 million	$ 5,950 million
NLP Exclusion Amount	$ 5,600 million	None
Description of Offering:		
Term and type of security	91-day bill	182-day bill
CUSIP number	912795 NU 1	912795 PH 8
Auction date	July 28, 2003	July 28, 2003
Issue date	July 31, 2003	July 31, 2003
Maturity date	October 30, 2003	January 29, 2004
Original issue date	May 1, 2003	July 31, 2003
Currently outstanding	$21,862 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

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

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

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.

(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.

(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

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

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

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

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
July 23, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Interest Rate:	1 1/2%	Issue Date:	July 31, 2003
Series:	N-2005	Dated Date:	July 31, 2003
CUSIP No:	912828BE9	Maturity Date:	July 31, 2005

High Yield: 1.510% Price: 99.980

All noncompetitive and successful competitive bidders were awarded securities at the high yield. Tenders at the high yield were allotted 1.86%. All tenders at lower yields were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 44,208,000	$ 24,268,620
Noncompetitive	731,503	731,503
FIMA (noncompetitive)	0	0
SUBTOTAL	44,939,503	25,000,123 1/
Federal Reserve	4,996,200	4,996,200
TOTAL	$ 49,935,703	$ 29,996,323

Median yield 1.465%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low yield 1.400%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 44,939,503 / 25,000,123 = 1.80

1/ Awards to TREASURY DIRECT = $606,210,000

JS-598

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
July 22, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	July 24, 2003
Maturity Date:	August 21, 2003
CUSIP Number:	912795NJ6

High Rate: 0.870%   Investment Rate 1/: 0.889%   Price: 99.932

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 68.58%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 28,848,884	$ 9,957,297
Noncompetitive	42,778	42,778
FIMA (noncompetitive)	0	0
SUBTOTAL	28,891,662	10,000,075
Federal Reserve	2,717,624	2,717,624
TOTAL	$ 31,609,286	$ 12,717,699

Median rate 0.865%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.840%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 28,891,662 / 10,000,075 = 2.89

1/ Equivalent coupon-issue yield.

JS - 599

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 24, 2003
JS-600

2003 - 2004 Priority Guidance Plan

Department of the Treasury
2003 2004 Priority Guidance Plan

Joint Statement by:

Pamela F. Olson
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury

Mark Everson
Commissioner
Internal Revenue Service

B. John Williams, Jr.
Chief Counsel
Internal Revenue Service

We are pleased to announce the release of the 2003 - 2004 Priority Guidance Plan.

In Notice 2003-26, we solicited suggestions from all interested parties, including taxpayers, tax practitioners, and industry groups. We recognize the importance of public input to formulate a Priority Guidance Plan that focuses resources on guidance items that are most important to taxpayers and tax administration.

We are committed to increased and more timely published guidance. The 2003-2004 Priority Guidance Plan contains 268 projects to be completed over a twelve-month period, from July 2003 through June 2004. In addition to the items on this year's plan, the Appendix lists the more routine guidance that is published each year.

This year's plan also includes five items under the Industry Issue Resolution Program. These items are described in a separate IRS News Release. The Industry Issue Resolution Program demonstrates our continuing efforts to work with taxpayers on a cooperative basis to resolve frequently disputed tax issues.

Last year, we instituted quarterly updates of the Priority Guidance Plan. We have concluded the quarterly updates provided us greater flexibility in addressing projects that arose during the year and provided the public increased opportunities for comments on the need for additional guidance. Consequently, we intend to update and republish the Priority Guidance Plan on a quarterly basis again this year to reflect additional guidance that we intend to publish in this plan year. These updates also may reflect guidance that we intend to publish in the following plan year. The quarterly updates will again allow us additional flexibility throughout the plan year to receive comments from taxpayers and tax practitioners relating to additional projects and to respond to developments that may arise during the plan year.

The published guidance process can be fully successful only if we have the benefit of the insight and experience of the taxpayers and practitioners who must apply the rules. Therefore, we invite the public to continue to provide us with their comments and suggestions as we write guidance throughout the plan year. Generally, recommendations for guidance will be reviewed for inclusion in the next quarterly update if received by August 31, 2003; November 30, 2003; or February 28, 2004, respectively. In addition to content, we welcome the views of taxpayers and practitioners on the dates by which guidance is necessary to implement statutory changes.

Additional copies of the 2003 -2004 Priority Guidance Plan can be obtained from the IRS website on the Internet (www.irs.gov) under Tax Professionals, IRS Resources, Administrative Information and Resources, 2003 2004 Priority Guidance Plan. Copies can also be obtained by calling Treasury's Office of Public Affairs at (202) 622-2960.

OFFICE OF TAX POLICY
AND
INTERNAL REVENUE SERVICE

2003-2004 PRIORITY GUIDANCE PLAN

CONSOLIDATED RETURNS

1. Guidance under section 1502 regarding transactions involving obligations of consolidated group members.

2. Guidance under section 1502 regarding rate or discount subsidy payments.

3. Final regulations under section 1502 regarding certain group structure changes.

4. Guidance under section 1502 regarding treatment of member stock.

CORPORATIONS AND THEIR SHAREHOLDERS

1. Final regulations regarding the effect of reorganizations on attribute reduction in respect of cancellation of indebtedness.

2. Guidance regarding redemptions of corporate stock.

3. Guidance regarding transactions involving the transfer or receipt of no net equity value.

4. Final regulations regarding taxable asset acquisitions and dispositions of insurance companies.

5. Guidance regarding the acquisition of businesses having certain nonqualified settlement funds.

6. Guidance regarding the effect of pre-closing changes of acquiror stock value on continuity of interest.

7 Guidance regarding the business purpose requirement under section 355.

8. Guidance regarding the active trade or business requirement under section 355(b).

9. Guidance regarding predecessors and successors under section 355(e).

10. Guidance regarding the assumption of liabilities in certain transfers of property.

11. Guidance regarding transfers of assets after putative reorganizations.

12. Guidance regarding certain cross-chain transactions.

13. Guidance under section 368(a)(1)(F).

14. Guidance under section 382.

15. Guidance under section 1374 regarding liquidations of C corporations.

EMPLOYEE BENEFITS

A. Retirement Benefits

1. Guidance on phased retirement arrangements.

2. Guidance on distribution rules for rollover contributions.

3. Guidance updating Rev. Rul. 81-100.

4. Proposed regulations under section 401(a)(4) for cash balance plans.

5. Regulations under section 401(a)(9) on required minimum distributions.

6. Guidance on whether employees of a section 501(c)(3) organization who are eligible to participate in a section 403(b) plan are excludable employees for section 401(k) and (m) plans.

7. Guidance relating to annuity plans under section 403(b).

8. Final regulations under section 408(q).

9. Guidance under section 409(p) on S corporation ESOPs.

10. Revenue ruling under section 410(b)(6)(c).

11. Guidance under section 411(a).

12. Guidance under sections 411(b)(1)(H) and 411(b)(2).

13. Guidance under section 411(d)(6).

14. Guidance on mortality tables.

15. Guidance on section 412(i) plans.

16. Additional transitional rules when a PEO retirement plan is converted to a multiple employer plan.

17. Regulations under section 415.

18. Guidance on section 416(g)(4)(H) for safe harbor 401(k) plans.

19. Guidance on use of electronic technologies for various retirement plan transactions.

20. Final regulations under section 417(a).

21. Guidance under section 417(e).

22. Guidance under section 420.

23. Guidance under section 457.

24. Revenue Procedure on model provisions for section 457(b) plans.

25. Guidance under section 3405 on actions by a duly authorized agent.

B. Executive Compensation, Health Care and Other Benefits, and Employment Taxes

1. Guidance under section 35 on credit for health care insurance costs of eligible individuals.

2. Guidance on election between taxable and nontaxable benefits.

3. Guidance under section 62(c) on payments to couriers.

4. Revenue ruling on electronic receipts and accountable plans.

5. Guidance under section 83.

6. Guidance on disability payments.

7. Guidance on HRAs.

8. Revenue ruling under section 125 on nonprescription drugs.

9. Guidance on debit cards.

10. Revenue ruling on the application of section 280G to various bankruptcy situations.

11. Guidance on health care provider incentive payments.

12. Final regulations on Incentive Stock Options.

13. Guidance on the employment taxation and reporting requirements applicable to interest in nonstatutory stock options and deferred compensation transferred to a former spouse incident to divorce.

14. Guidance under section 3121 regarding the definition of salary reduction agreement.

15. Guidance on the employment tax treatment of bonuses paid to employees on the signing of a collectively bargained agreement.

16. Guidance on FICA and FUTA tax with respect to incentive stock options under section 422 and employee stock purchase plans under section 423.

17. Notice on issues with respect to the treatment of choreworkers.

18. Guidance on the reporting procedures for successor organizations following Rev. Proc. 96-60.

19. Guidance under section 3504.

20. Revenue ruling under section 4980B on Medicare entitlement as a second qualifying event.

21. Guidance on tips paid to restaurant employees.

22. Guidance on the deposit requirements for employment tax in connection with the exercise of nonstatutory options.

EXCISE TAXES

1. Final regulations under section 4051 regarding the definition of highway vehicle in sections 145.4051 and 48.4061(a)-1.

2. Guidance regarding the definition of highway tractors subject to the heavy truck tax under section 4051.

3. Guidance under section 4051(a)(2) and (3) regarding suitability for use.

4. Guidance under section 4081 regarding the entry into the United States of taxable fuel.

5. Final regulations under section 4252 regarding toll telephone services.

6. Guidance under section 4261 regarding resellers of air transportation.

7. Guidance under section 4291 regarding the duties of the collector of collected excise taxes.

8. Proposed regulations under section 6416(a)(4) regarding claims for gasoline tax.

EXEMPT ORGANIZATIONS

1. Guidance on joint ventures between exempt organizations and for-profit companies.

2. Guidance on low-income housing partnerships and 501(c)(3) participation.

3. Guidance on downpayment assistance organizations.

4. Guidance on section 501(c)(4) organizations.

5. Guidance concerning the internet and unrelated business income tax.

6. Regulations under section 529 regarding qualified tuition programs.

7. Guidance on reporting requirements applicable to Coverdell education savings accounts.

8. Guidance on split interest trusts.

FINANCIAL INSTITUTIONS AND PRODUCTS

1. Proposed regulations regarding accruals on sales of REMIC regular interests between payment dates.

2. Guidance on system upgrade payments made to utilities.

3. Final regulations under section 263(g).

4. Guidance under section 265(a)(2).

5. Proposed regulations on notional principal contracts.

6. Revenue ruling under section 446 concerning the timing rules of hedging transactions not identified under section 1.1221-2(f).

7. Final regulations addressing the treatment of inducement fees for REMIC residual interests.

8. Proposed regulations addressing valuation under section 475.

9. Final regulations under section 475(e) and (f).

10. Guidance under section 851 on the treatment of certain obligations backed by Treasury securities for RIC diversification purposes.

11. Revenue ruling under section 856 on customary services performed by REITs.

12. Advance notice of proposed rulemaking on interest-only REMIC regular interests.

13. Final regulations on REMIC residual interests.

14. Guidance on credit card transactions.

15. Guidance under section 7872.

GENERAL TAX ISSUES

1. Proposed regulations under section 21 regarding the credit for household and dependent care expenses.

2. Final revenue procedure under section 23 regarding the credit for adoption expenses.

3. Guidance under section 32.

4. Guidance under section 41 regarding the research credit.

5. Final regulations under section 41 regarding the computation of the research credit in a controlled group.

6. Guidance under section 42.

7. Final regulations under sections 1.42-6 and 1.42-14 to conform to statutory changes.

8. Guidance under section 45D regarding the new markets tax credit.

9. Final regulations under sections 46 and 167 relating to normalization.

10. Guidance under sections 51 and 51A on qualified IV-A recipient.

11. Guidance regarding the section 59(e) election.

12. Revenue ruling regarding disaster relief payments to businesses.

13. Revenue ruling under sections 61 and 162 on the proper treatment of Medicaid rebates paid by pharmaceutical companies.

14. Guidance regarding the treatment of employee relocation costs.

15. Final regulations under section 121(c) regarding the reduced maximum exclusion for gain on the sale of a principal residence.

16. Revenue ruling under sections 121 and 1031 regarding like-kind exchange of a principal residence.

17. Guidance under section 152 regarding the release of a claim for exemption for a child of divorced or separated parents.

18. Guidance under section 165 regarding the deduction for worthless stock of subsidiaries for which an election under the check-the-box regulations has been made.

19. Final regulations under section 167 regarding the income forecast method.

20. Proposed and temporary regulations under section 168 relating to like-kind exchanges.

21. Final regulations under section 168 regarding depreciation of property for which the use changes.

22. Proposed and temporary regulations under sections 168 and 1400L regarding special depreciation allowance.

23. Guidance under section 168 regarding changes in classification of property.

24. Guidance under section 168 on asset classes and activity classes under Rev. Proc. 87-56.

25. Guidance under section 172 regarding specified liability losses.

26. Guidance under section 174 regarding the treatment of inventory property.

27. Guidance under section 179 on elections.

28. Final regulations under section 221 regarding interest on education loans.

29. Revenue procedure under section 274 regarding the use of statistical sampling.

30. Final regulations under section 280F regarding vans and light trucks.

31. Final regulations under section 465 regarding interest other than as a creditor.

32. Guidance under section 1031 regarding reverse like-kind exchanges of property.

33. Revenue ruling under section 1241 on cancellation of lease or distributor agreements.

34. Guidance on corporations chartered under Indian tribal law.

GIFTS, ESTATES AND TRUSTS

1. Guidance under section 642(c) regarding the contribution of a qualified conservation easement.

2. Final regulations under section 643 regarding state law definition of income for trust purposes.

3. Update revenue procedures under section 664 containing sample charitable remainder unitrust provisions.

4. Guidance under section 664 regarding dividends and capital gains for charitable remainder trusts.

5. Final regulations under section 671 regarding reporting requirements for widely-held fixed investment trusts.

6. Guidance under sections 671 and 2036 regarding tax reimbursement provisions in grantor trusts.

7. Guidance under section 2032 regarding section 301.9100 relief.

8. Guidance under section 2053 regarding post-death events.

9. Guidance under section 2632 regarding the election out of the deemed allocation of the generation-skipping transfer tax exemption.

10. Guidance under section 2642 regarding issues related to the generation-skipping transfer tax exemption.

11. Guidance under section 2642 regarding qualified severance.

12. Guidance under section 2651 regarding the predeceased parent rule.

13. Guidance under section 2704 regarding the liquidation of an interest.

INSURANCE COMPANIES AND PRODUCTS

1. Revenue ruling concerning reserves used to calculate required interest under section 812.

2. Guidance regarding substantially equal periodic payments under section 72(q).

3. Guidance regarding the 2001 CSO mortality tables.

4. Guidance regarding split-dollar life insurance.

INTERNATIONAL ISSUES

A. Subpart F/Deferral

1. Regulations on the allocation of subpart F income.

2. Regulations under section 959 on previously taxed earnings and profits.

3. Guidance on the PFIC provisions.

B. Inbound Transactions

1. Guidance on cross-border pension distributions.

2. Guidance under section 1441.

3. Guidance on securities lending.

4. Guidance on the treatment of certain financial products for withholding purposes.

5. Regulations under section 1446.

6. Regulations relating to the reporting of bank deposit interest.

C. Outbound Transactions

1. Guidance on international restructurings.

2. Guidance follow-up to Notice 2003-46.

D. Foreign Tax Credits

1. Regulations on the allocation of foreign taxes under section 901.

2. Regulations under sections 902 and 904.

3. Regulations on look-through treatment for 10/50 company dividends (see Notice 2003-5).

4. Regulations on the change of taxable year and foreign tax credits.

E. Transfer Pricing

1. Regulations on the treatment of cross-border services.

2. Regulations on cost sharing under section 482.

3. Guidance on the APA process (Rev. Proc. 96-53).

4. Regulations on global dealing.

F Sourcing and Expense Allocation

1. Guidance on interest expense apportionment.

2. Regulations on the allocation and apportionment of charitable contributions.

3. Regulations relating to the treatment of fringe benefits.

4. Guidance on the source of payments for cross-border use of property.

5. Regulations under sections 863(d) and (e).

G. Treaties

1. Treaty guidance on the determination of residence for dual resident companies.

2. Treaty guidance under the independent services article for nonresident partners.

3. Guidance on the procedures for claiming treaty waiver of insurance excise tax.

4. Guidance on reporting for Canadian RRSPs and other plans.

H. Other

1. Guidance on the definition of "qualified foreign corporation" for purposes of taxation of dividends received by individuals.

2. Regulations under section 269B.

3. Guidance on cross-border insurance issues.

4. Guidance on possessions issues.

5. Regulations concerning the treatment of currency gain or loss.

6. Regulations under section 1503(d).

PARTNERSHIPS

1. Guidance regarding partnership transactions under section 337(d).

2. Final regulations under section 460 regarding partnership transactions for long-term contracts.

3. Final regulations under section 704(b) regarding capital account book-up.

4. Guidance under section 704(b) regarding the allocation of foreign tax credits.

5. Guidance under section 704(c).

6. Guidance under section 707 regarding disguised sales.

7. Proposed regulations under section 721 regarding partnership interests issued for services and the treatment of compensatory partnership options.

8. Update of the section 751 regulations.

9. Final regulations under section 752 regarding the assumption of partner liabilities.

10. Guidance under section 752 where a general partner is a disregarded entity.

11. Guidance on the application of section 1045 to certain partnership transactions.

12. Guidance under section 6031 on the reporting requirements of tax-exempt bond partnerships.

13. Guidance under section 7701 regarding Delaware Statutory Trusts.

14. Guidance under section 7701 regarding disregarded entities and collection issues.

SUBCHAPTER S

1. Revenue ruling under section 1361 regarding QSub elections.

2. Guidance on the treatment of LIFO recapture under section 1363(d).

3. Guidance under section 7701 on deemed corporation entity elections for electing S corporations.

TAX ACCOUNTING

1. Final regulations under sections 162 and 263 regarding the deduction and capitalization of expenditures for intangible assets.

2. Regulations under sections 162 and 263 regarding the deduction and capitalization of expenditures for tangible assets.

3. Guidance under sections 162 and 263 regarding the deduction and capitalization of costs incurred to fertilize established timber stands.

4. Revenue ruling regarding the deduction and capitalization of costs incurred by utilities to maintain assets used to generate power.

5. Guidance under sections 165 regarding the treatment of preproduction costs of creative property.

6. Regulations under section 263A regarding the simplified service cost and simplified production methods.

7. Guidance under section 263A regarding "negative" additional section 263A costs.

8. Final regulations under sections 263A and 448 regarding adjustments under section 481(a) for certain changes in accounting method.

9. Regulations under section 381 regarding changes in method of accounting.

10. Guidance under section 442 regarding the period for taking into account adjustments resulting from certain changes in annual accounting period by pass-through entities.

11. Revenue procedure under section 446 regarding changes in method of accounting for rotable spare parts.

12. Regulations under section 446 regarding methods of accounting.

13. Temporary regulations under section 448 regarding the nonaccrual experience method.

14. Final revenue procedure under section 451 regarding the treatment of advance payments.

15. Revenue ruling under section 461 regarding the proper year for the deduction of payroll taxes on deferred compensation by accrual method taxpayers.

16. Regulations under section 468B regarding certain escrow funds.

17. Guidance on the tax treatment of vendor allowances involving buildouts and image upgrades.

18. Revenue ruling under section 1341 regarding the claim of right.

TAX ADMINISTRATION

1. Update Rev. Proc. 85-35 regarding claims for relief by victims of terrorism.

2. Final regulations under section 5891 regarding structured settlement factoring transactions.

3. Annual compilation of Tax Shelter Listed Transactions under section 6011.

4. Final regulations regarding electronic payee statements.

5. Proposed regulations regarding what constitutes a return under section 6020(b) for purposes of applying the failure to pay penalty.

6. Guidance regarding information reporting under section 6041 for commissions paid to insurance agents.

7. Revenue ruling regarding information reporting for royalty payments under sections 6041 and 6050N.

8. Final regulations regarding information reporting and backup withholding for purchasing card transactions.

9. Revenue procedure regarding Qualified Payment Card Agents.

10. Guidance regarding information reporting with respect to payments in lieu of dividends made to individuals.

11. Final regulations under section 6045(f) regarding the reporting of gross

proceeds to attorneys.

12. Final regulations under section 6050P regarding information reporting for cancellation of indebtedness.

13. Proposed regulations under section 6091 regarding hand carrying returns.

14. Proposed regulations under section 6103 regarding the disclosure of unrelated third party tax information in tax proceedings.

15. Final regulations under section 6103 regarding the definition of "agent".

16. Revenue procedure under section 6103 regarding fees charged for furnishing certain returns and return information.

17 Final regulations regarding the ability of a return preparer to furnish a completed copy of an income tax return to the taxpayer using a medium other than paper.

18. Withdrawal of regulations under former section 6152 relating to the election by a decedent's estate to pay income tax in installments.

19. Update Rev. Ruls. 75-365, 366, and 367 regarding interests in real estate held by a decedent.

20. Guidance regarding the use of summary assessment procedures with respect to claimed Black Reparations and similar credits.

21. Guidance under section 6213 regarding math error assessments based on a Form W-2.

22. Revenue ruling regarding the classification of items and the statute of limitations under the TEFRA partnership provisions.

23. Revenue ruling under section 6231 regarding the application of certain TEFRA partnership provisions to disregarded entities.

24. Final regulations under section 6302 regarding the minimum threshold for depositing FUTA taxes.

25. Proposed regulations under sections 6320 and 6330 regarding collection due process.

26. Notice regarding collection issues relating to property held as a tenancy by the entirety arising from the Supreme Court's opinion in United States v. Craft.

27. Revenue ruling regarding the limitations on setoff.

28. Revenue ruling regarding setoff with respect to a taxpayer in bankruptcy.

29. Proposed regulations under section 6655 regarding estimated tax payments by corporations.

30. Final regulations under sections 6662 and 6664 regarding penalties relating to tax shelters.

31. Revenue procedure regarding the submission and processing of offers-in-compromise.

32. Final regulations imposing a user fee for offers-in-compromise.

33. Guidance necessary to facilitate electronic tax administration.

34. Final regulations under section 7430 regarding qualified offers.

35. Proposed regulations under section 7430 regarding miscellaneous changes made by TRA 97 and RRA 98.

36. Update Rev. Proc. 87-24 regarding docketed Tax Court cases.

37. Proposed regulations regarding third party and John Doe summonses.

38. Revenue procedure regarding the early examination of questionable transactions.

39. Revisions to Circular 230 regarding practice before the IRS.

40. Revenue procedure expanding the prefiling agreement program.

TAX EXEMPT BONDS

1. Guidance under section 141 regarding naming rights.

2. Guidance on correction alternatives and voluntary compliance for tax exempt bond provisions.

3. Final regulations under section 141 on refundings.

4. Proposed regulations under section 141 regarding allocation and accounting provisions.

5. Regulations under section 142 regarding solid waste disposal facilities.

6. Guidance under section 143 regarding mortgage insurance fees.

7 Guidance under section 143 regarding average area purchase price.

8. Final regulations under section 148 regarding brokers' commissions and similar fees.

9. Guidance on arbitrage.

10. Guidance under section 150 regarding change in use provisions.

11. Guidance under section 1397E regarding qualified zone academy bonds.

APPENDIX - Regularly Scheduled Publications

JULY 2003

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in July 2003.

3. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

AUGUST 2003

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for

the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue procedure providing the amounts of unused housing credit carryover allocated to qualified states under section 42(h)(3)(D) for the calendar year.

3. Notice providing the inflation adjustment factor to be used in determining the enhanced oil recovery credit under section 43 for tax years beginning in the calendar year.

4. Notice providing the applicable percentage to be used in determining percentage depleting for marginal properties under section 613A for the calendar year.

5. Revenue ruling setting forth the terminal charge and the standard industry fare level (SIFL) cents-per-mile rates for the second half of 2003 for use in valuing personal flights on employer-provided aircraft.

6. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in August 2003.

7 Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

SEPTEMBER 2003

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue ruling providing the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September, 2003.

3. Revenue ruling under section 6621 regarding the applicable interest rates for overpayments and underpayments of tax for the period October through December 2003.

4. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in September 2003.

5. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

6. Revenue procedure under section 62 regarding the deduction and deemed substantiation of federal standard mileage amounts.

7. Revenue procedure under section 62 regarding the deduction and deemed substantiation of federal travel per diem amounts.

8. Update Notice 2002-62 to add approved applicants for designated private delivery service status under section 7502(f). Will be published only if any new applicants are approved.

OCTOBER 2003

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in October

2003.

3. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

4. Revenue procedure under section 1 and other sections of the Code regarding the inflation adjusted items for 2004.

5. Revenue procedure providing the loss payment patterns and discount factors for the 2003 accident year to be used for computing unpaid losses under section 846.

6. Revenue procedure providing the salvage discount factors for the 2003 accident year to be used for computing discounted estimated salvage recoverable under section 832.

7. Update of Rev. Proc. 2001-53 listing the tax deadlines that may be extended by the Commissioner under section 7508A in the event of a Presidentially-declared disaster or terrorist attack.

NOVEMBER 2003

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue ruling providing the "base period T-Bill rate" as required by section 995(f)(4).

3. Revenue ruling setting forth covered compensation tables for the 2004 calendar year for determining contributions to defined benefit plans and permitted disparity.

4. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in November 2003.

5. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

6. Update of Rev. Proc. 2001-52 regarding adequate disclosure for purposes of the section 6662 substantial understatement penalty and the section 6694 preparer penalty.

7. News release setting forth cost-of living adjustments effective January 1, 2004, applicable to the dollar limits on benefits under qualified defined benefit pension plans and other provisions affecting certain plans of deferred compensation.

DECEMBER 2003

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue ruling providing the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period October through December, 2003.

3. Revenue ruling under section 6621 regarding the applicable interest rates for overpayments and underpayments of tax for the period January through March 2004.

4. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in

December 2003.

5. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

6. Revenue procedure setting forth, pursuant to section 1397E, the maximum face amount of Qualified Zone Academy Bonds that may be issued for each state during 2004.

7. Federal Register notice on Railroad Retirement Tier 2 tax rate.

JANUARY 2004

1. Revenue procedure updating the procedures for issuing private letter rulings, determination letters, and information letters on specific issues under the jurisdiction of the Chief Counsel.

2. Revenue procedure updating the procedures for furnishing technical advice to certain IRS offices, in the areas under the jurisdiction of the Chief Counsel.

3. Revenue procedure updating the previously published list of "no-rule" issues under the jurisdiction of certain Associates Chief Counsel other than the Associate Chief Counsel (International) on which advance letter rulings or determination letters will not be issued.

4. Revenue procedure updating the previously published list of "no-rule" issues under the jurisdiction of the Associate Chief Counsel (International) on which advance letter rulings or determination letters will not be issued.

5. Revenue procedure updating procedures for furnishing letter rulings, general information letters, etc. in employee plans and exempt organization matters relating to sections of the Code under the jurisdiction of the Office of the Commissioner, Tax Exempt and Government Entities Division.

6. Revenue procedure updating procedures for furnishing technical advice in employee plans and exempt organization matters under the jurisdiction of the Commissioner, Tax Exempt and Government Entities Division.

7. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

8. Revenue ruling setting forth the prevailing state assumed interest rates provided for the determination of reserves under section 807 for contracts issued in 2003 and 2004.

9. Revenue ruling providing the dollar amounts, increased by the 2003 inflation adjustment for section 1274A.

10. Revenue ruling setting forth the amount that section 7872 permits a taxpayer to lend to a qualified continuing care facility without incurring imputed interest, adjusted for inflation.

11. Revenue procedure providing procedures for limitations on depreciation deductions for owners of passenger automobiles first placed in service during the calendar year; amounts to be included in income by lessees of passenger automobiles first leased during the calendar year; and the maximum allowable value of employer-provided automobiles first made available to employees for personal use in the calendar year.

12. Revenue procedure providing the domestic asset/liability percentages and the domestic investment yield percentages for taxable years beginning after December 31, 2002, for foreign companies conducting insurance business in the U.S.

13. Revenue procedure updating procedures for issuing determination letters on the qualified status of employee plans under sections 401(a), 403(a), 409, and

4975.

14. Revenue procedure updating the user fee program as it pertains to requests for letter rulings, determination letters, etc. in employee plans and exempt organizations matters under the jurisdiction of the Office of the Commissioner, Tax Exempt and Government Entities Division.

15. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in January 2004.

16. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

FEBRUARY 2004

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

3. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in February 2004.

MARCH 2004

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Notice providing resident population of the states for determining the calendar year state housing credit ceiling under section 42(h), the private activity bond volume cap under section 146, and the qualified public educational facility bond volume cap under section 142(k).

3. Revenue ruling providing the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March, 2004.

4. Revenue ruling under section 6621 regarding the applicable interest rates for overpayments and underpayments of tax for the period April through June, 2004.

5. Revenue ruling setting forth the terminal charge and the standard industry fare level (SIFL) cents-per-mile rates for the first half of 2004 for use in valuing personal flights on employer-provided aircraft.

6. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in March 2004.

7. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

APRIL 2004

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue ruling providing the average annual effective interest rates charged by each Farm Credit Bank District.

3. Notice providing the inflation adjustment factor, nonconventional fuel source credit, and reference price for the calendar year that determines the availability of the credit for producing fuel from a nonconventional source under section 29.

4. Revenue procedure providing a current list of countries and the dates those countries are subject to the section 911(d)(4) waiver and guidance to individuals who fail to meet the eligibility requirements of section 911(d)(1) because of adverse conditions in a foreign country.

5. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in April 2004.

6. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

MAY 2004

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in May 2004.

3. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

4. Revenue procedure providing guidance for use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio under section 145.

JUNE 2004

1. Revenue ruling setting forth tables of the adjusted applicable federal rates for the current month for purposes of sections 42, 382, 1274, 1288, and 7520.

2. Revenue ruling providing the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period April through June, 2004.

3. Revenue ruling under section 6621 regarding the applicable interest rates for overpayments and underpayments of tax for the period July through September 2004.

4. Notice providing the calendar year inflation adjustment factor and reference prices for the renewable electricity production credit under section 45.

5. Notice setting forth the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) for plan years beginning in June 2004.

6. Revenue ruling under section 472 providing the Bureau of Labor Statistics price indexes that department stores may use in valuing inventories.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 25, 2003
JS-601

Statement of
Assistant Secretary for Financial Institutions Wayne A. Abernathy
Regarding Committee Approval of FACT Act

"I wish to applaud the members of the House Financial Services Committee for their dedicated work, approving the Bachus-Hooley-Biggert-Moore bill, the Fair and Accurate Credit Transactions Act of 2003, by a vote of 61-3. Under the leadership of Chairman Oxley and Ranking Member Frank, the committee has acted promptly to take this important step toward ensuring that our national credit system continues to deliver expanded access to credit for all Americans while protecting the accuracy and security of their personal financial information. Significantly, this bill takes direct aim at the terrible problem of identity theft, giving consumers, financial institutions, and financial regulators powerful tools to fight this problem.

"This legislation is timely. Virtually every day brings news of the growing scope of identity theft. New estimates suggest that as many as 7 million Americans may have become victims of this crime in the last year. But the real tragedy is the way this crime disrupts the life of each one of its victims. The tools in this legislation will strengthen the fight against identity theft.

"In its current form, the Act incorporates many of the elements of the Administration proposal announced by Secretary Snow on June 30. I am heartened that this strong vote sets the stage for enacting this important package this year. The needs it addresses call for it. We look forward to continuing to work with the Congress in the legislative refinement process as the bill moves on to consideration by the full House of Representatives and by the Senate."

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 28, 2003
JS-603

Acting Assistant Secretary of the Office of Economic Policy
Mark J Warshawsky
Statement for the Treasury Borrowing Advisory Committee
of the Bond Market Association

The U.S. economy weathered a challenging series of storms in the past three years. Record-high taxes as a share of GDP, the bursting of the stock market bubble, and rising energy prices tipped the economy into recession in early 2001, subsequently exacerbated by the terrorist attacks. The recession has been determined to have ended in November 2001, but the economy continued to perform in a choppy manner even after that date from the impact of corporate scandals, unease over domestic security, and economic weakness abroad. Indeed, lingering effects of these headwinds, as well as more recent uncertainties relating to the Iraq war, led to a pace of economic growth late last year and in the first half of this year that was slower than desired and below potential.

In response, the Administration has worked to implement fiscal policies that stimulate the economy in the short-run and also have long-term payoffs by increasing the potential growth rate of the economy. Its three major stimulus programs that have been enacted in the past three years have by all accounts prevented the economy from experiencing a deeper recession, fostered the recovery, and will promote long-term growth. The economic effects of these programs are estimated to be sizable. If there had been no fiscal stimulus since the beginning of 2001, by the second quarter in 2003 real GDP would have been as much as 2 percent lower; the unemployment rate would have been nearly 1 percentage point higher; and as many as 1.5 million fewer Americans would be working. By the end of 2004 without the President's growth measures, real GDP would be as much as 3-1/2 to 4 percent lower; the unemployment rate would be 1.6 percentage points higher; and the economy would have 3 million fewer jobs than is currently projected for the baseline economy including the stimulus actions.

Signs of improvement are becoming apparent. Consumer confidence has strengthened from the war-depressed levels of February and March and contributed to a pickup in consumer spending. Unit sales of motor vehicles increased at a 10 percent annual rate in the second quarter; the retail sales components used in the calculation of personal consumption rose more strongly as the quarter progressed; and chain store sales posted strong gains through July. Healthy increases in consumers' disposable (after-tax) income are fueling the rise in spending as well, supplemented by the extraction of housing wealth due to mortgage interest rates that have been and still are the lowest that most Americans have ever seen.

Business confidence has also improved as earnings rose, profit expectations are higher and business financial conditions have become more accommodating. Since the last meeting of the Treasury Borrowing Advisory Committee, equity valuations have risen smartly. Most major indices are up between 8-1/2 to 11-1/2 percent since the end of April with the exception of the Nasdaq, which is up almost 20 percent. We believe these gains reflect not only the successful culmination of the war with Iraq but also a favorable reaction to the reductions in taxes on dividends and capital gains in the recently enacted Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which favor the use of equity capital. Indeed, we have seen a significant increase in announced dividend payments since the passage of JGTRRA. In the two months since the President signed the legislation, over 200 companies announced they would increase their dividend payouts. For some, the increase would amount to more than 200 percent.

Interest rates hit historic lows during the past three months, and despite some significant swings during the past quarter, the latest readings of the ten-year

Treasury yield are up only modestly compared to the end of April. The low rates allowed businesses to restructure debt, improve balance sheets, and increase cash flow. Yield spreads narrowed through most of the last three months, and high-yield spreads relative to Treasuries narrowed dramatically to a range not experienced since early 2000. While the recent back-up in long-term rates may dampen growth in housing refinancings, it should not pose much of a disruption to the sector overall since rates are still very low by historical standards. While refinancings have eased from May's peak levels, mortgage applications for home purchase are still very high.

Improved corporate financial conditions and stronger profits are laying the foundation for a solid pickup in investment. Replacement demand supported gains in real equipment and software investment in the last three quarters of 2002, and a return to growth is expected to have occurred in the second quarter of this year. That view was reinforced by last week's report of a strong gain in capital goods shipments in June, especially of computers and related products which surged in nominal terms at a 35 percent annual rate for the second quarter as a whole. Going forward, the favorable corporate environment, as well as the business equipment expensing provisions of JGTTRA, are expected to lead to accelerated growth in investment and, importantly, hiring.

For now, labor market conditions remain disappointing. Some firming may be building, as recent figures on initial unemployment claims show a drop of 55,000 in the last two weeks to the lowest level in five months. While that is a promising sign, seasonal adjustment difficulties in July due to auto plant shutdowns and other vacation closings make caution warranted when interpreting the weekly figures. Nonetheless, the outlook for the overall economic climate and for jobs has become much more promising now that the effects of the new stimulus legislation are beginning to take hold. Rapid productivity growth in the last few years, which in the long-run enhances standards of living, has so far allowed output to grow without the addition of new employees. Demand is projected to pick up substantially under JGTRRA, however, as the tax rate reductions and the rebates of the increased child credit boost consumer demand and the bonus expensing provision for equipment and software spur investment demand. In the third quarter alone, consumers will receive an extra $35 billion of spendable funds, according to the Joint Committee on Taxation.

The Administration's economic policy extends beyond the traditional "macroeconomic" arena. It also responds to problem "microeconomic" areas quickly as they arise. Most recently it is seeking to improve the pension security of workers and retirees. Improvements in disclosure is a goal of pension reform, reducing uncertainties for both beneficiaries and investors. The development of comprehensive pension reform proposals is underway, but we have put forward to Congress proposals for immediate improvements. These proposals would provide better information on plan funding levels while easing the funding burden on businesses in the initial years of the reforms, but then transition to more appropriate funding based on accurate measures of pension liabilities.

The principal element of reform that should be adopted is a phased-in plan to discount future benefit payments to today's dollars using discount rates based on a corporate bond based yield-curve, replacing the current use of the 30-year Treasury bond. Benefit payments to be made in future years would be discounted correctly by matching the rate on the yield curve appropriate to the time horizon of the pension plan's expected benefit payments. Other proposals include reducing the smoothing of interest rates used for discounting by phasing in a 90-day average instead of the current four-year average to better reflect current financial conditions; the publication of an estimate of how much current assets would cover earned benefits if the plan were terminated; and measures to limit benefit increases in severely underfunded plans sponsored by financially weak or bankrupt companies.

Overall, we feel the economy is poised for revival. JGTRRA not only provided tax relief but much needed reform in reducing the double-taxation of dividends and encouraging the use of equity capital. Our pension proposals will further help set corporate balance sheets on firmer footing. We believe that real GDP is on course to rise at a pace in excess of 3-1/2 percent in the second half of this year, a view that is corroborated by private-sector forecasters.

FROM THE OFFICE OF PUBLIC AFFAIRS

July 29, 2003
2003-7-29-11-37-45-21063

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 $80,950 million as of the end of that week, compared to $81,438 million as of the end of the prior week.

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

	July 11, 2003			July 18, 2003		
TOTAL		81,438			80,950	
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	7,514	13,353	20,866	7,461	13,285	20,746
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,235	2,681	14,916	12,169	2,668	14,837
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]			23,029			22,837
3. Special Drawing Rights (SDRs) [2]			11,583			11,486
4. Gold Stock [3]			11,044			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	July 11, 2003			July 18, 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:						

JS-604

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

	July 11, 2003			July 18, 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 leposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

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

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 29, 2003
JS-605

Treasury and IRS Continue Crackdown on Abuse of Life Insurance and Annuity Contracts

Today the Treasury Department and the Internal Revenue Service proposed a regulation that would further limit the use of life insurance and annuity contracts as a way to avoid current taxation of investment earnings. The regulation, together with Revenue Ruling 2003-92 issued on July 23, 2003, will prevent taxpayers from turning otherwise taxable investments in hedge funds and other entities into tax-deferred or tax-free investments merely by purchasing the investments through a life insurance or annuity contract.

"Life insurance and annuity contracts serve an important function – providing death benefit protection to the beneficiaries of an insured and providing lifetime retirement savings protection," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "Unfortunately some individuals have used the cover of insurance or annuities for the purpose of avoiding taxes on investment income. This regulation is another step in our ongoing efforts to stem tax avoidance transactions—we will continue to identify abusive transactions and take the steps necessary to prevent abuse."

Life insurance and annuity contracts receive favorable tax treatment in recognition of the importance of protecting loved ones against the potentially devastating financial consequences of death or the risk of exhausting savings while in retirement. Taxpayers should be able to purchase a life insurance or annuity contract secure in the knowledge that the contract complies with the tax laws. The tax rules applicable to life insurance and annuity contracts have not, however, kept pace with the development of the financial markets over the past fifteen years. These rules must be updated so that life insurance and annuity contracts may evolve to continue to serve their important function and to prevent their use for purposes Congress did not intend.

The regulation proposed today, Revenue Ruling 2003-92 and Revenue Ruling 2003-91 are an important part of the effort to modernize the rules. The proposed regulation requests taxpayer comments on how the rules governing the tax treatment of life insurance and annuity contracts should be updated to provide needed assurance to those who purchase these contracts for legitimate purposes, to prevent abuse, and to take account of the evolution of the financial markets.

Related Documents:

- The text of the proposed regulation

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-163974-02]

RIN 1545-BB77

Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document proposes removing provisions of the Income Tax Regulations that apply a look-through rule to assets of a nonregistered partnership for purposes of satisfying the diversification requirements of section 817(h) of the Internal Revenue Code. The Treasury Department and the IRS believe that removal of these provisions will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a nonregistered partnership funding a variable contract.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:RU (REG-163974-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:RU (REG-163974-02), Courier=s Desk, Internal Revenue Service, 1111 Constitution

Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: James Polfer, (202) 622-3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 817(d) defines a variable contract as an annuity contract, a life insurance contract, or a contract that provides funding of insurance on retired lives as described in section 807(c)(6). A variable contract must provide for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts (a segregated asset account) of the company under State law. In the case of an annuity contract, the amounts paid in, or the amounts paid out, must reflect the investment return and the market value of the segregated asset account. Section 817(d)(3)(A). In the case of a life insurance contract, the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the account. Section 817(d)(3)(B). In the case of a contract for funding of insurance on retired lives, the amounts paid in, or the amounts paid out, must reflect the investment return and the market value of the account. Section 817(d)(3)(C).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. Under section 817(h)(1), if a segregated asset account fails to be adequately diversified for a period, then the contracts supported by that segregated asset account shall not be treated as annuity, endowment, or life insurance contracts for that period and subsequent periods, even if the segregated asset account is adequately diversified in those subsequent periods. Section 1.817-5(c)(1) defines period as a calendar quarter. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.[1]

Section 817(h) was enacted by Congress in the Deficit Reduction Act of 1984 (Public Law No. 98-369). Congress enacted the diversification requirements of section 817(h) to Adiscourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles.@ H.R. Conf. Rep. No. 98-861, at 1055 (1984). In section 817(h)(1), Congress granted the Secretary broad regulatory authority to develop rules to carry out this intent. Pursuant to this authority, '1.817-5 sets forth the standards a segregated asset account must meet to be treated as adequately diversified within the meaning of section 817(h).

Section 817(h)(4) provides a look-through rule under which taxpayers do not treat the interest in a regulated investment company (RIC) or trust as a single asset of the

[1] Section 1.817-5(a)(2) provides a mechanism for insurance companies to avoid this result if certain enumerated correction procedures are satisfied.

segregated asset account but rather apply the diversification tests by taking into account the assets of the RIC or trust. Section 817(h) further provides that the look-through rule applies only if all of the beneficial interests in a RIC or trust are held by one or more general or segregated asset accounts of insurance companies (or affiliated companies), or by fund managers (or affiliated companies) in connection with the creation or management of the RIC or trust. AIn authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . . A H.R. Conf. Rep.at 1055.

Section 1.817-5(f)(1) of the regulations implements the Congressional directive to prescribe diversification standards by providing that if look-through treatment is available, a beneficial interest in a RIC, real estate investment trust, partnership, or trust that is treated under sections 671 through 679 as owned by the grantor or another person (investment company, partnership or trust) will not be treated as a single investment of a segregated asset account for purposes of testing diversification. Instead, a pro rata portion of each asset of the investment company, partnership, or trust will be treated as an asset of the segregated asset account.

Section 1.817-5(f)(2) provides more detailed rules for determining whether look-through treatment is available. Under '1.817-5(f)(2)(i), the look-through rule applies to any investment company, partnership, or trust if: (A) all the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies; and (B) public access to such investment company, partnership, or trust is available exclusively through the purchase of a variable contract. Section 1.817-5(f)(iii) provides exceptions to the general ownership limitations of '1.817-5(f)(2)(i), specifically permitting life insurance company general accounts, managers of the investment company, partnership or trust, pension or retirement plan trustees, and certain individuals whose investment falls into one of two limited classes.

Under '1.817-5(f)(2)(ii), the look-through rule applies to a partnership interest that is not registered under a Federal or State law regulating the offering or sale of securities. Unlike '1.817-5(f)(2)(i), satisfaction of the non-registered partnership look-through rule of '1.817-5(f)(2)(ii) is not explicitly conditioned on limiting the ownership of interests in the partnership to certain specified holders.

Under '1.817-5(f)(2)(iii), the look-through rule applies to a trust that is treated under sections 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

Section 1.817-5(g) provides examples of the application of the look-through rules of '1.817-5(f). Example (3) of '1.817-5(g) provides an example of the application of the '1.817-5(f)(2)(ii) non-registered partnership look-through rule.

Explanation of Provisions

This document contains proposed amendments to 26 CFR part 1 under section 817(h). These proposed amendments would remove '1.817-5(f)(2)(ii), which requires taxpayers to look through an interest in a nonregistered partnership, as defined in '1.817-5(f)(2)(ii), to determine whether a segregated asset account supporting a variable contract is adequately diversified within the meaning of section 817(h) and '1.817-5. In addition, the proposed regulations would conform the other provisions of '1.817-5 to the removal of '1.817-5(f)(2)(ii), and would remove Example (3) of '1.817-5(g).

The application of '1.817-5(f)(2)(i) to interests in nonregistered partnerships will be unchanged by the removal of '1.817-5(f)(2)(ii). Thus, look through treatment will be available for interests in a nonregistered partnership if: (A) all the beneficial interests in the nonregistered partnership (other than those described in '1.817- 5(f)(3)) are held by one or more segregated asset accounts of one or more insurance companies; and (B) public access to such nonregistered partnership is available exclusively (except as otherwise permitted in '1.817-5(f)(3)) through the purchase of a variable contract.

Reasons for Change

The Treasury Department and the IRS are concerned that '1.817-5(f)(2)(ii) is not consistent with Congressional intent because it is not explicitly subject to the public availability limitation of section 817(h). The Treasury Department and the IRS believe that removal of '1.817-5(f)(2)(ii) will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.

In addition, the Treasury Department and the IRS understand that certain taxpayers are purchasing contracts invested in partnerships that rely on the nonregistered partnership rule of '1.817-5(f)(2)(ii) to satisfy the diversification requirements of section 817(h). The Treasury Department and the IRS are concerned that these contracts are funded by interests in partnerships that are also available to certain limited classes of investors, specifically individuals that are Aqualified purchasers@ within the meaning of 15 U.S.C. ' 80a-2(a)(51) or Aaccredited investors@ as defined in Regulation D of the Securities Act of 1933.[2] The Treasury Department and the IRS believe that Congress intended to treat qualified purchasers and accredited investors as part of the general public when determining whether an investment is available for the purchase by the general public. Elimination of '1.817-5(f)(2)(ii) will limit access to interests in non-registered partnerships to the same holders that are permitted under '1.817-5(f)(2)(i), which does not include either qualified investors or accredited investors.

Proposed Effective Date

The Treasury Department and the IRS intend revocation of '1.817-5(f)(2)(ii) and Example (3) of '1.817-5(g) to be effective on the date the final regulations are published in the Federal Register. The revocation will be effective for all investments in nonregistered partnerships, including investments made prior to the effective date of the revocation that

---

[2] The Treasury Department and the IRS understand that many of the partnership interests that are available under these arrangements are interests in partnerships that operate as hedge funds, often established and operated in foreign jurisdictions. In many cases, interests in these partnerships are available for purchase directly by the general public as well as through the purchase of a variable contract. Taxpayers that purchase a variable annuity or life insurance contract are indirectly investing in partnership interests that are available for direct investment by the general public. By indirectly investing in these partnership interests through the purchase of a variable contract taxpayers defer tax on partnership earnings that might otherwise be currently taxable. The Treasury Department and the IRS believe that these arrangements (often marketed as Ainsurance wrappers@) are the type of overly investment oriented insurance and annuity arrangements that Congress sought to prevent when it enacted the diversification rules of section 817(h).

relied on the look-through rule of '1.817-5(f)(2)(ii) to satisfy the diversification requirements of section 817(h) and the regulations and do not meet the requirements of '1.817-5(f)(2)(i). However, arrangements in existence on the effective date of the revocation of '1.817-5(f)(2)(ii) will be considered to be adequately diversified if: (i) those arrangements were adequately diversified within the meaning of section 817(h) prior to the revocation of '1.817-5(f)(2)(ii) and (ii) by the end of the last day of the second calendar quarter ending after the effective date of the regulation, the arrangements are brought into compliance with the final regulations.

Special Analyses

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

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

The Treasury Department and the IRS specifically request comments on: (1) whether revocation of '1.817-5(f)(2)(ii) necessitates other changes to the look-through rules of '1.817-5(f), in particular whether the list of holders permitted by '1.817-5(f)(3) should be amended or expanded, and whether a non-pro-rata distribution of the investment returns of a segregated asset account should be permitted to take account of certain bonus payments to investment managers commonly referred to as incentive payments, (2) whether '1.817-5 should be updated to take account of changes to variable contracts since the final regulations were published in 1986, and (3) whether regulations are needed to address when a holder of a variable contract will be treated as the owner of assets held in a segregated asset account and, therefore, required to include earnings on those assets in income.[3]

---

[3] The Treasury Department and the IRS have issued a number of revenue rulings that provide guidance for determining whether the holder of a variable contract will be treated as the owner of assets held by a segregated asset account by virtue of the control the contract holder has over those assets. See Rev. Rul. 2003-92, 2003-33 I.R.B. __ (August 18, 2003); Rev. Rul. 2003-91, 2003-33 I.R.B. __ (August 18, 2003); Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12. See

Drafting Information

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

---

also Christoffersen v. U.S., 749 F.2d 513 (8th Cir. 1984), rev=g 578 F. Supp. 398 (N.D. Iowa 1984). These rulings apply general concepts of ownership that have developed in case law to conclude that a contract holder was the owner of assets held in the account that supported the contract holder=s annuity contract, and was therefore subject to current taxation on the earnings on those assets.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

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

PART 1 -- INCOME TAX

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

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

Section 1.817-5 also issued under 26 U.S.C. 817(h). * * *

Par. 2. Section 1.817-5 is amended as follows:

1. Paragraphs (f)(2)(ii) and (g) Example 3 are removed.

2. Paragraph (f)(2)(iii) is redesignated as paragraph (f)(2)(ii).

3. Paragraph (g) Example 4 is redesignated as paragraph (g) Example 3.

Deputy Commissioner (Services and Enforcement)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 29, 2003
JS-613

Minnesota Launches Federal Health Coverage Tax Credit

On Wednesday, July 30th, Minnesota will launch the on-site registration for the federal Health Coverage Tax Credit Program (HCTC) that will help cover the cost of health insurance premiums for many Minnesota residents.

The on-site registration will be held on Wednesday, July 30th from 10:00 a.m. to 5:00 p.m. at the National Guard Armory (600 Cedar Street) in St. Paul. Eligible Minnesota residents should have received their HCTC program kit in the mail which includes detailed information about eligibility and a registration form. They are encourage to attend the on-site registration.

"I am pleased that the interested parties in Minnesota have worked so hard to make the Health Coverage Tax Credit program available to more than 3,000 workers and their families," stated Treasury Secretary John Snow. "I commend them for their leadership in this unique partnership between state and federal governments, labor and participating health plans. This program is a real innovation in tax policy, one that we hope will lead the way for other innovations that help real people obtain the health care coverage that they need in a flexible and reliable way. We want to ensure that those who qualify for the credit get the help they need as quickly as possible. It's a bold step in the direction of affordable health care for all Americans."

The HCTC program requires that individuals eligible for TAA assistance or PBGC be enrolled in a qualified health plan. The qualified health plan for Minnesota is Minnesota Comprehensive Health Association, administered by Blue Cross Blue Shield of Minnesota.

In addition to the HCTC program, Minnesota received a National Emergency Grant for more than $7 million that will help provide temporary health coverage for an estimated 2,000 eligible Minnesota recipients.

The HCTC advance payments program begins nationally in August 2003. The Trade Adjustment Assistance Act President Bush signed into law last year included the new Health Coverage Tax Credit (HCTC). This program provides an advanced payment of 65% of the premium cost for a qualified health plan for individuals who are eligible to receive Trade Adjustment Assistance (TAA) benefits or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

For more information on a particular state and the health insurance programs that qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: **HCTC**.

-30-

Bureau of the Public Debt
United States Department of the Treasury

ureau Of The Public Debt Aids Savings Bonds Owners Ravaged By Severe Veather In Texas

OR IMMEDIATE RELEASE

ly 29, 2003

e Bureau of Public Debt took action to assist victims of severe weather in Texas by expediting the replacement or payment of United ates Savings Bonds for owners in those areas. The emergency procedures are effective immediately for paying agents and owners in xas affected by the storms. These procedures will remain in effect through the end of September 2003.

blic Debt's action waives the normal minimum holding period for Series EE and Series I savings bonds presented to authorized paying ents for redemption by residents of the affected area. Most financial institutions serve as paying agents for savings bonds.

e counties in Texas are: Bee, Brazoria, Calhoun, Galveston, Goliad, Jackson, Matagorda, Refugio and Victoria. Should additional unties be declared disaster areas the emergency procedures for savings bonds owners will also go into effect.

e replacement of bonds lost or destroyed will also be expedited by Public Debt. Bond owners should complete form PDF-1048, available most financial institutions or by writing the Kansas City Federal Reserve Bank's Savings Bond Customer Service Department, 925 and Avenue, Kansas City, Missouri 64198; phone (800) 333-2919. This form can also be downloaded from Public Debt's website at: w.publicdebt.treas.gov. Bond owners should include as much information as possible about the lost bonds on the form. This ormation should include how the bonds were inscribed, social security number, approximate dates of issue, bond denominations and ial numbers if available. The completed form must be certified by a notary public or an officer of a financial institution. Completed ms should be forwarded to Public Debt's Office of Investor Services, 200 Third St., Parkersburg, West Virginia 26106-1328. Bond ners should write the word "DISASTER" on the front of their envelopes, to help expedite the processing of claims.

JS 606

Bureau of the Public Debt
United States Department of the Treasury

ureau Of The Public Debt Aids Savings Bonds Owners Ravaged By Severe /eather In West Virginia

)R IMMEDIATE RELEASE

ly 29, 2003

e Bureau of Public Debt took action to assist victims of severe weather in West Virginia by expediting the replacement or payment of ited States Savings Bonds for owners in those areas. The emergency procedures are effective immediately for paying agents and ners in West Virginia affected by the storms. These procedures will remain in effect through the end of September 2003.

olic Debt's action waives the normal minimum holding period for Series EE and Series I savings bonds presented to authorized paying ents for redemption by residents of the affected area. Most financial institutions serve as paying agents for savings bonds.

e counties in West Virginia are: Boone, Berkeley, Cabell, Doddridge, Kanawha, Logan, Lincoln, Mason, McDowell, Mingo, Nicholas, ston, Putnam, Wayne and Wyoming. Should additional counties be declared disaster areas the emergency procedures for savings nds owners will also go into effect.

e replacement of bonds lost or destroyed will also be expedited by Public Debt. Bond owners should complete form PDF-1048, available most financial institutions or by writing the Richmond Federal Reserve Bank's Savings Bond Customer Service Department, 701 East d Street, Richmond, Virginia 23219; phone (804) 697-8000. This form can also be downloaded from Public Debt's website at: w.publicdebt.treas.gov. Bond owners should include as much information as possible about the lost bonds on the form. This ormation should include how the bonds were inscribed, social security number, approximate dates of issue, bond denominations and ial numbers if available. The completed form must be certified by a notary public or an officer of a financial institution. Completed ns should be forwarded to Public Debt's Office of Investor Services, 200 Third St., Parkersburg, West Virginia 26106-1328. Bond ners should write the word "DISASTER" on the front of their envelopes, to help expedite the processing of claims.

JS 607

Bureau of the Public Debt
United States Department of the Treasury

ureau Of The Public Debt Aids Savings Bonds Owners Ravaged By Severe Veather In Kentucky And Ohio

OR IMMEDIATE RELEASE

ly 29, 2003

e Bureau of Public Debt took action to assist victims of severe weather in Kentucky and Ohio by expediting the replacement or yment of United States Savings Bonds for owners in those areas. The emergency procedures are effective immediately for paying ents and owners in Kentucky and Ohio affected by the storms. These procedures will remain in effect through the end of September 03.

blic Debt's action waives the normal minimum holding period for Series EE and Series I savings bonds presented to authorized paying ents for redemption by residents of the affected area. Most financial institutions serve as paying agents for savings bonds.

e counties in Kentucky are: Boyd, Breathitt, Carter, Clay, Elliot, Floyd, Greenup, Harlan, Johnson, Knott, Lawrence, Leslie, Letcher, wis, Magoffin, Martin, Owsley, Perry, Pike, and Rowan. In Ohio, they are: Auglaize, Darke, Logan, Mercer, Shelby and Van Wert unties. Should additional counties be declared disaster areas the emergency procedures for savings bonds owners will also go into ect.

e replacement of bonds lost or destroyed will also be expedited by Public Debt. Bond owners should complete form PDF-1048, available most financial institutions or by writing the Pittsburgh Branch, Federal Reserve Bank of Cleveland's Savings Bond Customer Service partment, 717 Grant Street, Pittsburgh, Pennsylvania 152199; phone (412)261-7800. This form can also be downloaded from Public bt's website at: www.publicdebt.treas.gov. Bond owners should include as much information as possible about the lost bonds on the m. This information should include how the bonds were inscribed, social security number, approximate dates of issue, bond nominations and serial numbers if available. The completed form must be certified by a notary public or an officer of a financial titution. Completed forms should be forwarded to Public Debt's Office of Investor Services, 200 Third St., Parkersburg, West Virginia 106-1328. Bond owners should write the word "DISASTER" on the front of their envelopes, to help expedite the processing of claims.

33608

Bureau of the
Public
United States Department of the Treasury

ureau Of The Public Debt Aids Savings Bonds Owners Ravaged By Severe /eather In Indiana

ɔR IMMEDIATE RELEASE

ıly 29, 2003

e Bureau of Public Debt took action to assist victims of severe weather in Indiana by expediting the replacement or payment of United ates Savings Bonds for owners in those areas. The emergency procedures are effective immediately for paying agents and owners in diana affected by the storms. These procedures will remain in effect through the end of September 2003.

blic Debt's action waives the normal minimum holding period for Series EE and Series I savings bonds presented to authorized paying ents for redemption by residents of the affected area. Most financial institutions serve as paying agents for savings bonds.

e counties in Indiana are: Adams, Allen, Benton, Blackford, Boone, Carroll, Cass, Clay, Clinton, Delaware, Fountain, Fulton, Grant, milton, Hancock, Henry, Howard, Huntington, Jasper, Jay, Kosciusko, Madison, Marion, Miami, Montgomery, Morgan, Newton, Noble, rke, Pulaski, Randolph, Tippecanoe, Tipton, Vigo, Wabash, Wayne, Wells, White and Whitley. Should additional counties be declared ıaster areas the emergency procedures for savings bonds owners will go into effect.

e replacement of bonds lost or destroyed will also be expedited by Public Debt. Bond owners should complete form PDF-1048, available most financial institutions or by writing the Minneapolis City Federal Reserve Bank's Savings Bond Customer Service Department, 90 nnepin Avenue, Minneapolis, Minnesota 64198; phone (613) 204-5000. This form can also be downloaded from Public Debt's website www.publicdebt.treas.gov. Bond owners should include as much information as possible about the lost bonds on the form. This ormation should include how the bonds were inscribed, social security number, approximate dates of issue, bond denominations and ·ial numbers if available. The completed form must be certified by a notary public or an officer of a financial institution. Completed ms should be forwarded to Public Debt's Office of Investor Services, 200 Third St., Parkersburg, West Virginia 26106-1328. Bond ners should write the word "DISASTER" on the front of their envelopes, to help expedite the processing of claims.

JS 609

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
July 28, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	July 31, 2003
Maturity Date:	January 29, 2004
CUSIP Number:	912795PH8

High Rate: 0.980% Investment Rate 1/: 1.000% Price: 99.505

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 81.61%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 33,661,195	$ 15,217,420
Noncompetitive	1,157,493	1,157,493
FIMA (noncompetitive)	625,200	625,200
SUBTOTAL	35,443,888	17,000,113 2/
Federal Reserve	5,950,379	5,950,379
TOTAL	$ 41,394,267	$ 22,950,492

Median rate 0.965%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.950%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 35,443,888 / 17,000,113 = 2.08

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $934,281,000

http://www.publicdebt.treas.gov

JS 610

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
July 28, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	July 31, 2003
Maturity Date:	October 30, 2003
CUSIP Number:	912795NU1

High Rate: 0.945% Investment Rate 1/: 0.964% Price: 99.761

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 65.14%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 29,134,562	$ 13,968,622
Noncompetitive	1,519,322	1,519,322
FIMA (noncompetitive)	512,200	512,200
SUBTOTAL	31,166,084	16,000,144 2/
Federal Reserve	5,255,889	5,255,889
TOTAL	$ 36,421,973	$ 21,256,033

Median rate 0.935%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.900%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 31,166,084 / 16,000,144 = 1.95

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,232,560,000

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.
July 28, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $20,000 million to refund an estimated $17,000 million of publicly held 4-week Treasury bills maturing July 31, 2003, and to raise new cash of approximately $3,000 million.

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

The Federal Reserve System holds $13,849 million of the Treasury bills maturing on July 31, 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 612

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED JULY 31, 2003

July 28, 2003

Offering Amount.........................$20,000 million
Maximum Award (35% of Offering Amount)...$ 7,000 million
Maximum Recognized Bid at a Single Rate..$ 7,000 million
NLP Reporting Threshold.................$ 7,000 million
NLP Exclusion Amount....................$11,400 million

Description of Offering:
Term and type of security...........28-day bill
CUSIP number........................912795 NK 3
Auction date........................July 29, 2003
Issue date..........................July 31, 2003
Maturity date.......................August 28, 2003
Original issue date.................February 27, 2003
Currently outstanding...............$44,639 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 daylight saving time on auction day
Competitive tenders:
Prior to 1:00 p.m. eastern daylight saving time on auction day

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 29, 2003
JS-613

Minnesota Launches Federal Health Coverage Tax Credit

On Wednesday, July 30th, Minnesota will launch the on-site registration for the federal Health Coverage Tax Credit Program (HCTC) that will help cover the cost of health insurance premiums for many Minnesota residents.

The on-site registration will be held on Wednesday, July 30th from 10:00 a.m. to 5:00 p.m. at the National Guard Armory (600 Cedar Street) in St. Paul. Eligible Minnesota residents should have received their HCTC program kit in the mail which includes detailed information about eligibility and a registration form. They are encourage to attend the on-site registration.

"I am pleased that the interested parties in Minnesota have worked so hard to make the Health Coverage Tax Credit program available to more than 3,000 workers and their families," stated Treasury Secretary John Snow. "I commend them for their leadership in this unique partnership between state and federal governments, labor and participating health plans. This program is a real innovation in tax policy, one that we hope will lead the way for other innovations that help real people obtain the health care coverage that they need in a flexible and reliable way. We want to ensure that those who qualify for the credit get the help they need as quickly as possible. It's a bold step in the direction of affordable health care for all Americans."

The HCTC program requires that individuals eligible for TAA assistance or PBGC be enrolled in a qualified health plan. The qualified health plan for Minnesota is Minnesota Comprehensive Health Association, administered by Blue Cross Blue Shield of Minnesota.

In addition to the HCTC program, Minnesota received a National Emergency Grant for more than $7 million that will help provide temporary health coverage for an estimated 2,000 eligible Minnesota recipients.

The HCTC advance payments program begins nationally in August 2003. The Trade Adjustment Assistance Act President Bush signed into law last year included the new Health Coverage Tax Credit (HCTC). This program provides an advanced payment of 65% of the premium cost for a qualified health plan for individuals who are eligible to receive Trade Adjustment Assistance (TAA) benefits or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

For more information on a particular state and the health insurance programs that qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: **HCTC**.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

July 29, 2003
JS-614

Treasury Issues Final Regulations to Ease Administrative Burdens in Treatment of Dual Consolidated Losses

Today the Treasury Department and the Internal Revenue Service issued final regulations that will reduce administrative burdens for taxpayers under existing rules regarding dual consolidated losses. In particular, the new regulations eliminate the need for taxpayers to enter into a closing agreement with the IRS when a U.S. corporate group with a history of such losses is acquired by another U.S. corporate group.

Existing regulations provide special rules for losses incurred by U.S. corporations that are also subject to tax in a foreign jurisdiction and for losses incurred in foreign branches of U.S. corporations. Under these rules, such "dual consolidated losses" generally cannot be used to offset the income of U.S. affiliates unless the consolidated group files an agreement with its U.S. federal income tax return under which it agrees to recapture the losses, and pay an interest charge, if the losses are ever used in the foreign jurisdiction. The regulations specify a number of other events that may trigger recapture of the dual consolidated losses, including certain corporate mergers and acquisitions. Exceptions from the recapture requirement are available in certain cases where liability for the recapture continues after the acquisition, provided that the affected taxpayers satisfy specified procedural requirements. In particular, they have been required to enter into a closing agreement with the IRS with respect to the dual consolidated losses.

The Treasury Department and the IRS have determined that such closing agreements pose an unnecessary administrative burden in certain cases, where other existing rules sufficiently protect the government's interest in collecting the tax and interest due from any future recapture of the dual consolidated losses. Accordingly, the new regulations eliminate this requirement for transactions occurring on or after January 1, 2002.

Related Documents:

- The text of the final regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service (IRS)

26 CFR Parts 1 and 602

[TD 9084]

RIN 1545-AY27

Dual Consolidated Loss Recapture Events

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1503(d) regarding the events that require the recapture of dual consolidated losses. These regulations are issued to facilitate compliance by taxpayers with the dual consolidated loss provisions. The regulations generally provide that certain events will not trigger recapture of a dual consolidated loss or payment of the associated interest charge. The regulations provide for the filing of certain agreements in such cases. This document also makes clarifying and conforming changes to the current regulations.

DATES: Effective Dates: These regulations are effective January 1, 2002.

FOR FURTHER INFORMATION CONTACT: Kenneth D. Allison or Kathryn T. Holman, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1583. Responses to this collection of information are required to obtain the benefit of avoiding entering into a closing agreement with the IRS.

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

The estimated annual burden per recordkeeper varies from 1 to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

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

Books or records relating to a collection of information must be retained as long as their contents might 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

Final regulations implementing section 1503(d) were adopted by TD 8434 (1992-C.B. 240), on September 9, 1992, and published in the **Federal Register** at 57 FR 41079 (REG-106879-00). On August 1, 2002, proposed regulations amending the final regulations, to reduce administrative burdens in certain cases, were published in the

Federal Register at 67 FR 49892. Three written comments were received. No public hearing was requested or held. After consideration of the comments, these final regulations are adopted by this Treasury decision. The changes and clarifications made in the final regulations in response to the comments received are discussed below.

Explanation of Provisions and Summary of Comments

Section 1503(d) generally provides that a "dual consolidated loss" of a domestic corporation cannot offset the taxable income of any other member of the corporation's consolidated group. The statute, however, authorizes the issuance of regulations permitting the use of a dual consolidated loss to offset the income of a domestic affiliate if the loss does not offset the income of a foreign corporation under foreign law.

Section 1.1503-2(g)(2)(i) currently permits a taxpayer to elect to use a dual consolidated loss of a dual resident corporation or separate unit to offset the income of a domestic affiliate by filing an agreement ((g)(2)(i) agreement) under which the taxpayer certifies that the dual consolidated loss has not been, and will not be, used to offset the income of another person under the laws of a foreign country. Section 1.1503-2(g)(2)(iii) provides that, in the year of a "triggering event," the taxpayer must recapture and report as gross income the amount of a dual consolidated loss that is subject to the (g)(2)(i) agreement and must pay the interest charge required by paragraph (g)(2)(vii). Section 1.1503-2(g)(2)(iv)(B), however, provides that specified acquisitions are not considered to be triggering events if certain conditions are satisfied. In particular, the parties to the acquisition must enter into a closing agreement with the IRS under section 7121, and the acquiring corporation or consolidated group must file a new (g)(2)(i) agreement with respect to the loss.

The proposed regulations provided that a triggering event generally does not occur in two types of acquisitions, without any requirement to enter into a closing agreement or file a new (g)(2)(i) agreement: (1) when an unaffiliated dual resident corporation or unaffiliated domestic owner that filed a (g)(2)(i) agreement becomes a member of a consolidated group; and (2) when a dual resident corporation, or domestic owner, that is a member of a consolidated group that filed a (g)(2)(i) agreement (the acquired group) becomes a member of another consolidated group (the acquiring group) in an acquisition, so long as each member of the acquired group that is an includible corporation under section 1504(b) is included immediately after the acquisition in a consolidated U.S. income tax return filed by the acquiring group. Instead, in such cases, the proposed regulations required the filing of an information statement, whereby taxpayers would provide the IRS with most of the information that otherwise would have been provided in a new (g)(2)(i) agreement.

The proposed regulations were intended to relieve the burden of entering into a closing agreement in circumstances where the several liability imposed by §1.1502-6, in combination with the original (g)(2)(i) agreement, would provide for liability by the acquiring group sufficiently comparable to that provided by a closing agreement. A commentator, who raised questions regarding comparable liability under §1.1502-6 in such cases, in particular with respect to the interest charge, recommended that the regulations should retain the existing requirement for the acquiring corporation or consolidated group to enter into a new (g)(2)(i) agreement with respect to the dual consolidated loss. Although the IRS and Treasury believe that §1.1502-6 provides an independent assurance of several liability, the recommendation to retain the existing requirement for a new (g)(2)(i) agreement has been adopted in these final regulations. The IRS and Treasury have concluded that the intended reduction in administrative burden can be accomplished through the elimination of the requirement to enter into a closing agreement in the cases specified in the proposed regulations. Moreover, with the retention of the requirement to file a new (g)(2)(i) agreement, the requirement in the proposed regulations to file a separate information statement containing essentially the same information has been eliminated. Additional changes have been made to clarify the nature of the new (g)(2)(i) agreement.

The commentators also suggested that any affiliated dual resident corporation or affiliated domestic owner should be permitted to join the acquiring group without causing a triggering event, regardless of whether all members of the consolidated group that filed the original (g)(2)(i) agreement also join the acquiring group, provided that the acquiring group files a new (g)(2)(i) agreement. This suggestion has not been adopted in these final regulations. The final regulations contain a modified description of the types of transactions for which a closing agreement no longer is required, to make clear that all members of an acquired group (or their successors-in-interest) must be members of the acquiring group immediately after the acquisition (i.e., that no member of the acquired group, or its successor-in-interest, is excluded from the acquiring group due to any applicable restriction such as section 1504(a)(3) or section 1504(c)). However, the IRS and Treasury are continuing to consider this suggestion as well as other alternatives for further reducing the administrative and compliance burdens under the section 1503(d) regulations, and invite additional comments in this regard.

In order to accomplish the intended reduction in administrative burdens promptly, the final regulations are applicable with respect to transactions otherwise constituting triggering events occurring on or after January 1, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that also have a foreign affiliate, 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, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Kenneth D. Allison and Kathryn T. Holman of the Office of Associate Chief Counsel (International). 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

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts1 and 602 are amended as follows:

PART 1--INCOME TAXES

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

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

Section 1.1503-2 also issued under 26 U.S.C. 1502 * * *

Par. 2. In §1.1503-2 paragraphs (g)(2) and (h)(1) are amended as follows:

1. Paragraphs (g)(2)(iv)(B)(1), introductory text, and (g)(2)(iv)(B)(1)(i) are revised.

2. Paragraph (g)(2)(iv)(B)(1)(ii) is removed.

3. Paragraphs (g)(2)(iv)(B)(1)(iii) and (iv) are redesignated as paragraphs (g)(2)(iv)(B)(1)(ii) and (iii), respectively.

4. Paragraph (g)(2)(iv)(B)(2) and (g)(2)(iv)(B)(2)(iii) are revised and redesignated as paragraph (g)(2)(iv)(B)(3) and (g)(2)(iv)(B)(3)(iii) respectively.

5. Newly designated paragraph (g)(2)(4)(B)(3)(iii) is revised.

6. New paragraph (g)(2)(iv)(B)(2) is added.

7. Paragraph (g)(2)(iv)(D) is added.

8. Paragraph (h)(1) is amended by adding a sentence at the end of the

paragraph.

The revisions and additions read as follows:

§1.1503-2 Dual consolidated loss.

* * * * *

(g) * * *

(2) * * *

(iv) * * *

(B)* * *(1) If all the requirements of paragraph (g)(2)(iv)(B)(3) of this section are met, the following events shall not constitute triggering events requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section:

(i) An affiliated dual resident corporation or affiliated domestic owner becomes an unaffiliated domestic corporation or a member of a new consolidated group (other than in a transaction described in paragraph (g)(2)(iv)(B)(2)(ii) of this section);

* * * * *

(2) If the requirements of paragraph (g)(2)(iv)(B)(3)(iii) of this section are met, the following events shall not constitute triggering events requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section--

(i) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group;

(ii) A consolidated group that filed an agreement under this paragraph (g)(2) ceases to exist as a result of a transaction described in §1.1502-13(j)(5)(i) (other than a transaction in which any member of the terminating group, or the successor-in-interest of such member, is not a member of the surviving group immediately after the terminating group ceases to exist).

(3) If the following requirements (as applicable) are satisfied, the events listed in paragraphs (g)(2)(iv)(B)(1) and (2) of this section shall not constitute triggering events requiring recapture under paragraph (g)(2)(vii) of this section.

* * * * *

(iii) The unaffiliated domestic corporation or new consolidated group must file, with its timely filed income tax return for the taxable year in which the event described in paragraph (g)(2)(iv)(B)(1) or (2) of this section occurs, an agreement described in paragraph (g)(2)(i) of this section (new (g)(2)(i) agreement), whereby it assumes the same obligations with respect to the dual consolidated loss as the corporation or consolidated group that filed the original (g)(2)(i) agreement with respect to that loss. The new (g)(2)(i) agreement must be signed under penalties of perjury by the person who signs the return and must include a reference to this paragraph (g)(2)(iv)(B)(3)(iii).

* * * * *

(D) Example. The following example illustrates the application of paragraph (g)(2)(iv)(B)(2)(ii) of this section:

Example. (i) Facts. C is the common parent of a consolidated group (the C Group) that includes DRC, a domestic corporation. DRC is a dual resident corporation and incurs a dual consolidated loss in its taxable year ending December 31, Year 1. The C Group elects to be bound by the provisions of this paragraph (g)(2) with respect to the Year 1 dual consolidated loss. No member of the C Group incurs a dual consolidated loss in Year 2. On December 31, Year 2, stock of C is acquired by D in a transaction described in § 1.1502-13(j)(5)(i). As a result of the acquisition, all the C Group members, including DRC, become members of a consolidated group of which D is the common parent (the D Group).

(ii) Acquisition not a triggering event. Under paragraph (g)(2)(iv)(B)(2)(ii) of this section, the acquisition by D of the C Group is not an event requiring the recapture of the Year 1 dual consolidated loss of DRC, or the payment of an interest charge, as described in paragraph (g)(2)(vii) of this section, provided that the D Group files the new (g)(2)(i) agreement described in paragraph (g)(2)(iv)(B)(3)(iii) of this section.

(iii) Subsequent event. A triggering event occurs on December 31, Year 3, that requires recapture by the D Group of the dual consolidated loss that DRC incurred in Year 1, as well as the payment of an interest charge, as provided in paragraph (g)(2)(vii) of this section. Each member of the D Group, including DRC and the other former members of the C Group, is severally liable for the additional tax (and the interest charge) due upon the recapture of the dual consolidated loss of DRC.

* * * * *

(h) * * *

(1) * * * Paragraph (g)(2)(iv)(B)(2) of this section shall apply with respect to transactions otherwise constituting triggering events occurring on or after January 1, 2002.

* * * * *

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.601 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1503-2	1545-1583
* * * * *	

Robert E. Wenzel

Deputy Commissioner for Services and Enforcement.

Approved: July 17, 2003

Pamela F. Olson

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
July 29, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	July 31, 2003
Maturity Date:	August 28, 2003
CUSIP Number:	912795NK3

High Rate: 0.970% Investment Rate 1/: 0.981% Price: 99.925

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 56.06%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 43,694,030	$ 19,957,200
Noncompetitive	42,893	42,893
FIMA (noncompetitive)	0	0
SUBTOTAL	43,736,923	20,000,093
Federal Reserve	2,642,801	2,642,801
TOTAL	$ 46,379,724	$ 22,642,894

Median rate 0.960%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.940%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 43,736,923 / 20,000,093 = 2.19

1/ Equivalent coupon-issue yield.

JS 615

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 29, 2003
JS-616

Snow, Evans & Chao Visit Wisconsin On The Jobs & Growth Tour

Today, Treasury Secretary John Snow, Commerce Secretary Don Evans and Labor Secretary Elaine L. Chao visited Wisconsin on their "Jobs & Growth Tour" to discuss the state of the economy and the recently enacted jobs and growth plan as well as other efforts by President Bush to create jobs, strengthen the economic recovery and increase workers' standards of living.

Today, during the "Jobs and Growth Tour" Secretaries Snow, Evans and Chao participated in town hall style meetings, roundtables, and tours. They met with families, workers, manufacturers, local business leaders, economic officials, small business owners, seniors and individual investors. They toured the Harley Davidson Powertrain Operations Plant in Wauwatosa, WI; participated in a small Business Roundtable event at Conger Industries in Green Bay, WI; and held a child tax credit/marriage penalty tax event at Culver's of Wausau in Mosinee, WI.

"We are seeing first-hand the signs that President Bush's Jobs and Growth plan is taking root and beginning to have a positive effect on the economy," stated Treasury Secretary Snow. "It has been great to meet the workers, families and small business owners in Wisconsin that are working hard to create more jobs and help the economy grow. With the arrival of the child credit checks starting this week, families in Wisconsin will have more money to use as they see fit—they can use it for back to school supplies, saving for their child's education, or for a family vacation."

"Secretaries Snow, Chao and I are traveling in Wisconsin so we can collect real-time economic information from real American people," said Commerce Secretary Evans. "Today's leg of the Jobs and Growth tour allowed us to hear from scores of workers, small business owners and families about the economy and reinforced President Bush's belief that the strength of the American economy lies in our people and our factories, not within the halls of Washington D.C."

"We had a good day meeting and talking with the working men and women in Wisconsin who are the backbone of our economy and our country," stated Labor Secretary Elaine L. Chao. "They are the ones who will benefit most by the President's Jobs and Growth plan which will help stimulate new economic growth and create more jobs."

Many hardworking Wisconsin families and small businesses benefit greatly from the Jobs and Growth Act. As an example:

- More than **1.8 million** taxpayers in Wisconsin will have lower income tax bills in 2003 under the Jobs and Growth Tax Relief Reconciliation Act of 2003.
- **405,000** business taxpayers can use their tax savings to invest in new equipment, hire additional workers, and increase pay.
- Nearly **1.5 million** married couples and single filers will benefit from the acceleration to 2003 of the expansion of the 10-percent bracket scheduled for 2008.
- More than **495,000** taxpayers in Wisconsin will benefit from the acceleration to 2003 of the reductions in income tax rates in excess of 15-percent scheduled for 2004 and 2006.
- More than **760,000** married couples in Wisconsin 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.

- More than **515,000** married couples and single parents in Wisconsin 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.
- **510,000** taxpayers in Wisconsin will benefit from the reduced tax rates on capital gains and dividends.

SOURCE: Counts are for the number of returns filed in 2002 that would have benefited from the package. These estimates are based on tabulations from all individual income tax returns processed by the Internal Revenue Service in 2002. Most of these returns covered tax year 2001.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
JS-617

TESTIMONY OF ROBERT STANLEY NICHOLS NOMINEE TO BE TREASURY ASSISTANT SECRETARY FOR PUBLIC AFFAIRS, DEPARTMENT OF THE TREASURY BEFORE THE SENATE FINANCE COMMITTEE

Chairman Grassley, Ranking Member Baucus, and members of the Senate Finance Committee, thank you for the opportunity to appear before you today. It is a great privilege to be considered for the position of Assistant Secretary of the Treasury for Public Affairs. I am honored that President Bush has nominated me to serve in this position, and that you are taking the time to consider my nomination. I also thank Secretary Snow for his leadership and for having the confidence in me to serve in this post.

Mr. Chairman, the Treasury Department – an agency with a long and rich history of service to the nation dating back to 1789 - is at the center of President Bush's efforts to create jobs and economic growth. If I am confirmed by the Senate, I look forward to making the case publicly for the President's economic agenda and to keeping you and your committee informed of Treasury's work.

Within the department, the Assistant Secretary for Public Affairs plays a leading role in educating the American people about tax and currency policy, debt management, Social Security and Medicare financing, and a host of international issues that impact our prosperity. A large part of this job is representing the President's views on an issue to the media, and through them, to the general public. I look forward to doing that and working with the press corps to keep the American people informed about the decisions that are being made here in Washington, D.C.

Members of the committee, while I am proud to have been nominated for many fundamental reasons, there is one I wish to share today. I deeply believe that President Bush's recent economic growth proposal moves the U.S. economy in the right direction. It is an investment in the American people and their future. It will give the economy the boost it needs to grow and create jobs so that millions of Americans can be more secure and confident, both now and in the future. It is an honor to be associated with this President's economic leadership.

Mr. Chairman, I am grateful to you for bringing me before this Committee and respectfully ask that I be permitted to introduce my wife Rebecca to you and members of the Committee.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
JS-618

Testimony Of Teresa Mullett Ressel Nominee To Be Treasury Assistant Secretary For Management And Cfo, Department Of The Treasury Before The Senate Finance Committee

Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee, thank you for asking me to appear before the Committee today.

I am honored to be nominated by the President as the Assistant Secretary for Management and Chief Financial Officer for the Department of the Treasury. If confirmed, I look forward to working with this committee on a common goal effective financial and operational leadership at the Treasury Department. Treasury provides an anchor for the financial management across the Government. A helpful way to think about this structure is to consider the IRS as essentially the accounts receivable centerpiece for the Government, the Financial Management Service as accounts payable, and the Bureau of Public Debt as the cash flow system for debt. All of the bureaus offer operational challenges, and I look forward to working with this committee to meet or exceed your expectations.

Sound Treasury policy enables a healthy economy both domestically and internationally. In many ways, the Chief Operating Office role through the position of Assistant Secretary for Management facilitates this policy by providing services to Treasury bureaus and supporting each and every policy office within Main Treasury, including Tax Policy, International Affairs and Domestic Finance.

When Congress looks towards the Treasury Department to implement new initiatives, the Management function serves as the engine to drive change and, if confirmed, I pledge to work closely with Congress to achieve these changes. Human Capital, Technology Platforms, and Procurement Offices coupled with Small Business Outreach, as well as sound, stable Financial Management practices are required to execute our Mission at the Treasury Department. It is that collection of functional areas, plus DC Pensions, that reports to the position of Assistant Secretary for Management.

I want to thank and recognize my colleagues at the Treasury Department. I have worked at Treasury for two years, first as the Deputy Assistant Secretary for Management and Budget, and currently as Acting Assistant Secretary for Management. September 11th served to highlight many of the contributions by our Federal Workforce. I am constantly impressed by their dedication and competence and I view the opportunity to lead these employees as the Assistant Secretary for Management as an honor and a privilege.

I want to thank my family, especially my husband Chip, and our three children, Rick, Steve and Claire. Our 9 year old son, Rick, suggested his allowance should be $10 a week because the Treasury building is on the back of the bill, but rest assured, my role as CFO at home has given me lots of practice in frugal financial stewardship. I would also like to thank my mother, Lee Mullett, for all of her support. My father died shortly after I was asked to serve as Acting ASM in November 2002, but he is with me here today in spirit. His unwavering patriotism towards the United States has been an inspiration to me.

I am proud of this opportunity to serve our great Nation and I look forward to working with the Committee in the future. I will be happy to answer any questions that you may have. Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
JS-620

Treasury Secretary John W. Snow Testimony on Strengthening Consumer Interests of the Fair Credit Reporting Act Before the Committee on Banking, Housing, and Urban Affairs

Thank you Chairman Shelby, Senator Sarbanes, and other distinguished Members of this Committee for this opportunity to testify on the Administration's proposal to strengthen the use of the Fair Credit Reporting Act (FCRA) to promote consumer interests.

All consumers have two important interests, the promotion of which is the central purpose of the FCRA. One is the interest in improved access to credit and other financial services. The other is the interest in the accuracy and security of their financial information. The Administration proposes to remove the sunsets on the uniform standards and focus these standards and the FCRA even more on meeting these two key consumer interests.

A hallmark of our country is readily available credit. In fact, it is not too much to say that ready access to credit on competitive terms is an integral part of the economic security and well-being of American families. All over the country, Americans depend on competitive credit markets to realize the dream of home ownership, to finance their cars, to pay for college, and meet a variety of other needs. More than two-thirds of Americans now own their own home, and 9 out of 10 homes are purchased with a mortgage. As another example, consumer credit helps finance the vast majority of the more than 15 million cars and trucks that consumers purchase annually.

The FCRA's uniform national standards for information sharing operate to expand the opportunity for consumers to access credit and financial services - they make your reputation as a borrower portable, so that you don't have to establish your good name from scratch in every city you visit, or every store where you shop.

The Council of Economic Advisers estimates that, if states passed laws that significantly deviated from the national uniform standards of the Fair Credit Reporting Act, 280,000 home mortgage applications that are now approved each year would be denied that's $22 billion in new mortgages annually. Access to accurate and reliable financial information is particularly important for approving loans to first-time home buyers, for example.

This democratization of credit has especially benefited minority and lower income families. For example, from 1995 to 2001, the percentage of minorities holding mortgages increased significantly - one-sixth of minorities who qualified for mortgages in 2001 would not have qualified in 1995, a higher rate of improvement in home ownership than for families overall. In addition, the percentage of minority families with credit cards has risen substantially. From 1995 to 2001, the percentage of African American families holding credit cards rose from 39.4% to 55.8%. More generally, since 1970, credit access by U.S. households in the bottom half of income distribution has experienced the most rapid growth. National uniform standards help all Americans participate more fully in the miracle of modern credit markets. We need to accelerate that process and do nothing to slow it down.

Perhaps the most serious threat to financial consumers today is identity theft. Identity thieves are clever, adaptable, and heartless. Indeed, many identity thieves specifically target the most vulnerable members of society - families of the recently deceased, seniors, hospital patients, and men and women serving our nation overseas. These schemes come in many forms and I have described several of the more deplorable schemes elsewhere. Today I would like to cite still another example, as reported just last week, that demonstrates how clever and adaptable the thieves are:

- Using a $100 commercially available keystroke logging program, an identity thief in New York stole over 450 online banking passwords during a two year period. The scam began with the thief installing a keyboard-sniffing program on public Internet terminals at thirteen locations scattered throughout Manhattan. Unwitting customers using the terminals then had their keystrokes logged as they accessed information. With username and password information in hand, the thief then used the victims' personal and financial information to open new accounts under their names and transferred money from the victims' legitimate accounts into the new, fraudulent ones.

Many Americans have worked hard for years to build and keep good credit histories. In today's information-driven economy, one of your most important personal assets is your reputation, your credit history. The statistics are there - and have been cited by many. For example, a recent study reports that identity theft has been seriously under-reported and asserts that 7 million Americans were victims of identity theft last year alone.

We may never know what the right number is. But one thing we do know is that there are far too many victims of identity theft and that the crime is spreading.

One of the most distressing aspects of identity theft is how quickly an identity thief can damage your credit history and how long it can take to undo the damage. A recent General Accounting Office study found that victims spend on average 175 hours trying to recover from the crime. In many cases, recovery can take even longer, and involve thousands of dollars in legal and other expenses. The costs are so significant that a market in identity theft insurance is now developing.

Our national information sharing system can and should be improved to do more in the fight against identity theft. As we do so, it is important to understand that national standards for sharing such information are an important tool in the fight against identity theft. When a thief tries to steal your identity and open an account in your name, he is posing as you, hiding behind a mask that he has constructed out of bits of information about your identity. Bankers or merchants can stop the would-be thief right in the act, before the crime is committed, if they have timely access to the right information. With the right information about your true identity, financial institutions can ask validating questions and peer behind the thief's mask. In other words, your banker can stop the identity thief if your banker is more familiar with you than the thief is. National uniform standards make timely access to full and accurate information possible, giving financial institutions the tools to stop many identity theft assaults before they can succeed, information moving faster than the thieves.

On June 30, I announced the Administration's proposals to make the Fair Credit Reporting Act an even more effective instrument to protect consumer financial data from fraud and abuse, enhancing the quality and integrity of that information, while at the same time expanding consumer access to credit and other financial services.

We are extremely pleased that several of these proposals are contained in bipartisan legislation now pending before the House of Representatives, approved last week by the Financial Services Committee by a strong 61 to 3 vote. We look forward to working with you as the Senate considers these issues. In my testimony today, I wish to focus on five of our proposals:

- Free credit reports upon request. To achieve these important goals of the Fair Credit Reporting Act we would be wise to engage the consumers themselves. A basic tool to place in the hands of consumers is access to their credit reports, once a year, upon request, free of charge. Consumers should be offered the opportunity to review their credit reports for accuracy and completeness. We believe that this proposal will not only help stop identity theft, but that it will lead to improvement in the overall quality of the information in the credit reporting system. After all, no one has a stronger interest in ensuring the accuracy of their credit reports than consumers themselves. As the overall quality of the information improves, everyone will benefit consumers, merchants, financial institutions, and the economy as a whole.

- National Security Alert System. We recommend that the uniform standards include a national security alert system. Under such a system, consumers who have been victimized or are in danger of being victimized can put banks and merchants on their guard against any further efforts to impersonate the consumer, thus making it much harder to steal one's identity.
- Red Flags. We propose that the bank regulators also be put on the watch for patterns followed by identity thieves, red flags that indicate the likelihood of fraudulent activity. The regulators would provide notice of these red flags to the institutions that they supervise and put them on the watch for these telltale signs. Further, the regulators would verify in their bank examinations that these warning signs are being heeded, fining those institutions where lack of attention results in customer losses. I regard this proposal to be a very important part of the package. One of the challenges in fighting identity theft is that identity thieves are adaptable. They are always looking for ways to exploit systems and procedures that we set up to thwart them. It is important, therefore, that regulators and financial institutions be equally adept in catching them. To be effective and not become soon out of date, this proposal avoids locking today's tell-tale signs in the statute, but instead gives regulators the flexibility to adapt to new identity theft schemes and to establish procedures to thwart them and foil the efforts of the would-be thieves, and it gives financial institutions increased incentives to be on guard as well.
- Prohibition on the sale or transfer of identity theft debt. Another important Administration proposal is a prohibition on the sale or transfer of debt for collection that a creditor knows is the result of identity theft. Too often, consumers labor for hours persuading a creditor that they were the victims of identity theft only to find that they must begin the process all over again with a new creditor who has purchased the debt from the original creditor. Our proposal would help reduce re-pollution of consumer's credit files and save consumers countless hours of needless hassle.
- Adverse Action Notices. The Administration proposes granting the FTC specific rulemaking authority that would require notices to consumers when their credit scores caused them to be offered less favorable rates than for which they applied.

These are a few highlights of the package of proposals we have offered, that would build upon and amplify the use of the FCRA to promote consumer access to credit within a context of improved accuracy and security of personal financial information. Enactment of this package will make our national information sharing system even more a servant of consumer interests.

Given the important role that the national standards of the Fair Credit Reporting Act play in expanding access to credit and maintaining the accuracy and security of consumers' information, it should come as no surprise that national information sharing standards benefit our economy as a whole. It seems so basic that we take it for granted, but an integral part of our economy's success is our confidence in financial services such as bank services, insurance, and investment products. Our credit markets helped the American economy weather the serious shocks we've experienced over the last three years - a recession, 9-11, homeland security, corporate accounting fraud and so on.

And there should be no doubt that the national uniform standards of the Fair Credit Reporting Act help make our credit market more robust. According to the Council of Economic Advisors, if the national standards were to expire, and states adopted new laws currently under consideration, a minimum of 3.5% of loans currently approved would be denied to maintain the same level of credit risk. This could put as much as $270 billion of consumer credit in jeopardy.

We look forward to working with this Committee and the full Senate to move a strong package of reforms into law this year and ensure that the Fair Credit Reporting Act becomes an even more effective tool for meeting the financial interests of American consumers. Accomplishing this task is vital to the future of our economy. With improved national standards, we can make great strides to protect our citizens against identity theft, while holding open the doors of credit to many more American families of every income and background.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 31, 2003
js621

Snow & Evans Praise Senate Commerce Committee for Approving Legislation to Make Internet Tax Moratorium Permanent

Calling it a "win for innovation," Treasury Secretary John Snow and Commerce Secretary Don Evans today praised the Senate Commerce Committee for approving a permanent extension of the moratorium on taxes on Internet access and on multiple or discriminatory taxes on electronic commerce. Snow and Evans made the following statement:

"A permanent moratorium means permanent innovation. Keeping the Internet free of multiple or discriminatory taxes on electronic commerce will help create an environment for innovation and help ensure that electronic commerce remains a vital part of our economy. As policy makers, we need to encourage the roll out of new Internet services and not stifle innovation by imposing new taxes."

"We applaud Chairman McCain for his leadership on this important issue and recognize all the other members of the Committee including Senators Allen and Wyden who were instrumental in pushing for a permanent moratorium."

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 31, 2003
JS-622

President's Commission on the U.S. Postal Service Delivers Report to President Treasury Secretary Snow Commends Commission for Its Work; Urges Postal Service to Study Recommendations Closely

The President's Commission on the United States Postal Service today delivered its final report to Treasury Secretary John W. Snow and President George W. Bush. The report, capping eight months of public meetings on key issues, outlines the Commission's recommendations for legislative and administrative steps that will ensure the long-term viability of postal services in the United States.

"I want to express my appreciation to Commission Co-chairmen Jim Johnson and Harry Pearce for their extraordinary leadership in examining the full breadth of issues facing the Postal Service," said Secretary Snow. "We all know how important this institution is to the nation, and we commend the Commission for proposing a comprehensive business model that will adequately prepare the Postal Service for the 21st century."

The nine-member bipartisan Commission was established by President Bush on December 11, 2002, with the task to articulate a vision for the future of the Postal Service that ensures efficient, cost-effective operations while minimizing the financial exposure to the taxpayer. The Commission's report contains recommendations for legislative and administrative reforms in the Postal Service's business model, use of technology, partnerships with the private sector, and the work force. The Commission was clear in urging that there not be any reduction of mail service that American citizens currently enjoy.

"The Commission has done a terrific job, and we must consider its findings carefully," said Secretary Snow. "The Administration looks forward to working with the Postal Service to ensure they continue to implement reforms within current statutes. We also look forward to working with Congress to examine the full range of issues which may require legislation."

The report can be found on the Commission's website,
www.treasury.gov/offices/domestic-finance/usps

-30-

Report(s):

- USPS Final Report

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

July 31, 2003
JS-623

New Health Coverage Tax Credit Program Begins Nationwide August 1st

Starting August 1st, the federal Health Coverage Tax Credit (HCTC) program will begin operation nationwide, providing advance payments for health insurance premiums. The Trade Adjustment Assistance Act President Bush signed into law last year included the HCTC to help lower the cost of health insurance and provide much-needed relief to eligible state residents. The HCTC pays for 65% of the qualified health insurance premiums for people potentially eligible for the credit. People who are eligible for the HCTC include those eligible for certain Trade Adjustment Assistance benefits, or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

"I am pleased to launch the Health Coverage Tax Credit program-making health insurance more affordable for workers, retirees and their families," stated Treasury Secretary John Snow. "This start-up is itself an accomplishment. In less than a year, our team has successfully built from the ground up a new system to help people pay for health insurance coverage. This represents a unique partnership between state and federal governments, labor and participating health plans. This program is a real innovation in tax policy, one that we hope will lead the way for other innovations that help real people obtain the health care coverage that they need in a flexible and reliable way. We want to ensure that those who qualify for the credit get the help they need as quickly as possible. This is a bold step in the direction of affordable health care for all Americans."

To receive the HCTC an individual must be enrolled in a qualified health insurance plan. Some individuals may already be enrolled in a form of insurance that is automatically qualified, such as COBRA continuation coverage, certain spousal coverage, or in some cases individual (non-group) health insurance coverage. Recipients can receive their benefits either in advance - to help pay health plan premiums as they come due - or in a lump sum when they file their federal tax returns.

The processes and technologies to support the advance payment option have been developed in record time, and are now fully operational. An HCTC Customer Contact Center and toll free number are also now operational and an HCTC section is available on the IRS website. HCTC Program Kits have been created and are being sent to all potentially eligible individuals nationwide. The HCTC Program Kit includes eligibility and health plan information, questions and answers and a registration form.

The HCTC program team met with state officials across the country to help them understand and implement the HCTC for their citizens and to help train appropriate state agency employees about the program. Pilot and pre-registration activities were conducted in Maine and Pennsylvania, respectively, where already over a thousand people have registered for the advance tax credit. On-site registration sessions will continue to be held in additional states through September.

Attached is a state-by-state map showing the most current preliminary estimate for the number of people potentially eligible for the HCTC. These numbers are being updated regularly as actual program information becomes available.

The national HCTC Customer Contact Center is open for callers at 1-866-628-HCTC (4282). For more information on a particular state and the health insurance programs that may qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: HCTC.

-30-

Related Documents:

- Publication Data

HCTC | Health Coverage Tax Credit
Federal • State • Private Industry

Potentially Eligible Population Based on July 2003 Estimates

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 31, 2003
JS-624

Written Statement of R. Richard Newcomb, Director Office of Foreign Assets Control U.S. Department of the Treasury Before The Committee on Governmental Affairs United States Senate Hearings on Terrorism Financing: Origination, Organization and Prevention
July 31, 2003

Madam Chairman, members of the Committee, thank you for the opportunity to testify on OFAC's efforts to combat terrorist support networks that threaten United States citizens and property worldwide. It's a pleasure to be here. Please allow me to begin with a brief general overview of the problem, as I see it.

Foundations of Terrorist Financing and Support
The threat of terrorist support networks and financing is real, and it has been our mission to help identify and disrupt those networks. The vast majority of the world's Muslims are peaceful, though a committed, vocal, and well-organized minority is competing to mobilize a new generation in the tools and trade of Jihad.

There is much we know about how such radical Islamic terrorist networks were established and still thrive. Wealthy and influential individuals and families based in the Middle East have provided seed money and support to build a transnational support infrastructure that terrorists have used for their purposes. This network, fueled by deep-pocket donors and often controlled by terrorist organizations, their supporters or those willing to look the other way, includes or implicates banks, businesses, NGOs, charities, social services organizations, schools, mosques, madrassas, and affiliated terrorist training camps and safe houses throughout the world.

The terrorist networks are well-entrenched and self-sustaining, though vulnerable to U.S., allied and international efforts applying all tools at our disposal. Looking forward, please allow me to explain how we have come to this view and present the strategy, being implemented in coordination with other Federal agencies including the Departments of Defense, State, Justice, Homeland Security, the FBI, the intelligence community and other agencies, to choke off the key nodes in the transnational terrorist support infrastructure.

OFAC Mission and Experience on Counterterrorism
The primary mission of the Office of Foreign Assets Control ("OFAC") of the U.S. Department of the Treasury is to administer and enforce economic sanctions against targeted foreign countries and foreign groups and individuals, such as terrorists and terrorist organizations and narcotic traffickers, which pose a threat to the national security, foreign policy or economy of the U.S. OFAC acts under general Presidential wartime and national emergency powers, as well as specific legislation, to prohibit transactions and freeze (or "block") assets subject to U.S. jurisdiction. Economic sanctions are intended to deprive the target of the use of its assets and deny the target access to the U.S. financial system and the benefits of trade, transactions and services involving U.S. markets, businesses and individuals. These same authorities have also been used to protect assets within the U.S. jurisdiction of countries subject to foreign occupation and to further important U.S. nonproliferation goals.

OFAC currently administers and enforces 26 economic sanctions programs pursuant to Presidential and Congressional mandates. Active enforcement of these programs is a crucial element in preserving and advancing the foreign policy and national security objectives that underlie these initiatives that are usually taken in conjunction with diplomatic, law enforcement and occasionally military action. In 1977, the Congress passed the International Emergency Economic Powers Act

("IEEPA"), which serves as the primary statutory authority for a Presidential declaration of a national emergency in peacetime for the purpose of imposing economic sanctions.

Many "country-based" sanctions programs are part of the U.S. government's response over time to the threat to U.S. national security and foreign policy posed by international terrorism. The Secretary of State has designated seven countries – Cuba, North Korea, Iran, Libya, Iraq, Sudan and Syria - as supporting international terrorism. Most of these countries are subject to comprehensive economic sanctions, including: Cuba (1963); Iran (1979 and again in 1987); Libya (1986); and Sudan (1997). Comprehensive sanctions against Iraq, originally imposed in 1990, were recently lifted although the national emergency remains in place. Comprehensive sanctions against North Korea, originally imposed in 1950, were lifted in 2000, except with respect to North Korean imports and "Weapons of Mass Destruction" blockings. Syria is not subject to comprehensive sanctions; however, certain financial transactions involving all terrorism list countries including Syria are regulated.

The origins of OFAC's involvement in the fight against terrorism stem from the initial conception of terrorism as being solely state-sponsored. OFAC's mandate in the realm of terrorism was to compile available evidence establishing that certain foreign entities or individuals were owned or controlled by, or acting for on behalf of, a foreign government subject to an economic sanctions program. Such entities and individuals become "specially designated nationals," ("SDNs") and are subject to the same sanctions as the foreign government to which they are related.

Authorities to Target Non State Organizations, Individuals and Entities
In January 1995, the President used the IEEPA authorities to deal with the threat to U.S. foreign policy and national security posed by terrorists who threaten to disrupt the Middle East Peace Process. This marked the beginning of the use of IEEPA sanctions authorities to target terrorists, terrorist groups and their sources of fundraising. This action, implemented through Executive Order 12947, opened the door to new programs and expanded the use of economic sanctions as a tool of U.S. foreign policy to target groups and individuals, as well as foreign governments. During the late 1990s, IEEPA authorities were used to issue additional Executive orders imposing sanctions on Al-Qaeda, and Usama bin Ladin. These E.O.s also provide authority to designate and sanction entities or individuals that are owned or controlled by, act for or on behalf of, or that provide material or financial support to Al-Qaeda or Usama bin Ladin.

Following this model, in October 1995, during a speech at a UN 50th anniversary celebration, the President announced the concept of adapting E.O. 12947 to target significant foreign narcotics traffickers centered in Colombia, i.e., the Colombian drug trafficking cartels. That IEEPA program, under E.O. 12978, began with the President identifying four Cali Cartel drug kingpins, and has expanded into a key tool in the fight against the Colombian cartels. As of today, 14 Colombian drug kingpins, 340 entities, and 470 other individuals associated with the Cali, North Valle, and North Coast cartels' and their business empires have been designated as Specially Designated Narcotics Traffickers ("SDNTs") under E.O. 12978.

Building on the successes of the Colombian cartels Program under E.O. 12978, in December 1999, Congress enacted the Foreign Narcotics Kingpin Designation Act ("Kingpin Act"), originally introduced by Senators Coverdell and Feinstein, modeled on IEEPA and OFAC's SDNT program. It provides a statutory framework for the President to impose sanctions against foreign drug kingpins and their organizations on a worldwide scale. Like the terrorism program under E.O. 12947 and the SDNT program under E.O. 12978, the Kingpin Act is directed against the individual or entity and their support infrastructure, not against the countries in which they are imbedded. Since the first list of kingpins was issued under that authority, 38 foreign drug kingpins (these are in addition to the 14 Colombian drug kingpins designated under E.O. 12978), 11 derivative companies, and 15 derivative individuals have been designated.

The Congress, in 1996, passed the Antiterrorism and Effective Death Penalty Act ("AEDPA"). AEDPA makes it a criminal offense to: (1) engage in a financial transaction with the government of a country designated as supporting international terrorism; or (2) provide material support or resources to a designated Foreign Terrorist Organization (FTO).

Currently, 36 FTOs are subject to OFAC-administered sanctions. These FTOs have been designated by the Secretary of State in consultation with the Secretary of the Treasury and the Attorney General. Under the AEDPA and OFAC's implementing regulations, U.S. financial institutions must maintain control over all funds in which an FTO has an interest and report those actions to OFAC. OFAC is the coordination point with State and Justice on FTO designations and also has responsibility for coordinating with the financial community, the FBI, State, and other Federal agencies in implementing the prohibitions of the AEDPA.

Authorities in Response to September 11th

The President harnessed these economic powers and authorities in launching the war against terrorism. In response to the terrorist attacks of September 11, and pursuant to the powers available to the President under IEEPA, President Bush issued Executive Order 13224, "Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism" declaring that the acts of grave terrorism and the threats of terrorism committed by foreign terrorists posed an unusual and extraordinary threat to the national security, foreign policy, and economy of the United States. E.O. 13224, as amended, authorizes the Secretary of the Treasury, in consultation with the Department of State, Department of Justice and the Department of Homeland Security, to implement the President's authority to systemically and strategically attack terrorists, terrorist organizations and terrorist support networks.

This order prohibits U.S. persons from transacting or dealing with individuals and entities owned or controlled by, acting for or on behalf of, assisting or supporting, or otherwise associated with, persons listed in the Executive Order. Those designated and listed under the Executive Order are known as "Specially Designated Global Terrorists", or SDGTs. Violations of the E.O. with respect to SDGTs are subject to civil penalties; and if the violation is willful, persons may be criminally charged. The Executive Order also blocks "all property and interests in property of [designated persons] that are in the United States or that hereafter come within the United States, or that hereafter come within the possession or control of United States persons[.]"[1]

The PATRIOT Act, passed in October 2001, amends IEEPA to provide critical means and authority to OFAC to counter terrorist financing. The Act has enhanced OFAC's ability to implement sanctions and to coordinate with other agencies by clarifying OFAC's authorities to block assets of suspect entities prior to a formal designation in "aid of an investigation." This critical authority helps prevent the flight of assets and prevents the target from engaging in potential damaging behavior or transactions.

Prior to the passage of the PATRIOT Act, OFAC was wary of relying on classified information under IEEPA programs, because, unlike the Antiterrorism and Effective Death Penalty Act of 1996, IEEPA did not contain a provision explicitly authorizing submission of classified information to a court, in camera and ex parte, upon a legal challenge to a designation. The new PATRTIOT Act authority has greatly enhanced our ability to make and defend designations by making it absolutely clear that OFAC may use classified information in making designations without turning the material over to an entity or individual that challenges its designation.

Rolling FTO's into SDGT's Makes War on Terrorist Infrastructure Global

On November 2, 2001, the U.S. took a significant step in the War on Terrorism when the Secretary of State, in consultation with the Secretary of the Treasury and the Attorney General, utilized the new authorities in E.O. 13224 to designate 22 Foreign Terrorist Organizations (FTOs) as Specially Designated Global Terrorists (SDGTs). This action expanded the War on Terrorism beyond Al-Qaeda and the Taliban and associated individuals and entities to include Hamas, Hizballah, the FARC, the Real IRA and others. As then recognized by the State Department, this action created a truly global war on terrorism and terrorist financing and demonstrated our commitment to continue and expand our efforts against all terrorist groups posing a threat to the United States, our citizens, our interests, and our allies. Currently, there are 36 FTOs which are also designated as SDGTs.

To date, the U.S. has designated 281 individuals and entities as SDGTs pursuant to E.O. 13224. 202 of these entities are associated with either Al-Qaeda or the Taliban which provides the basis to notify these names to the UN for listing pursuant to United Nations Security Resolutions (UNSCRs) 1267, 1333, 1373, 1390 and 1455. The United States has worked diligently with the UN Security Council to adopt international resolutions reflecting the goals of our domestic executive orders and providing the mechanisms for UN member states to freeze terrorist-related assets.

Using Designation Authorities in Cooperation with International Partners
The emerging international threat of Al Qaeda in the 1990s necessitated OFAC's participation in the U.S. government's focus on developing information and strategies against terrorist financing and infrastructures. In that context, it was clear that the cooperation of foreign governments, including Saudi Arabia, Kuwait and the UAE, would be critical in impeding the flow of funds to terrorists.

Having developed an understanding of how terrorist support networks operate, we began direct engagements with allies. For example, in June 1999, an OFAC delegation met with Finance Ministry, Intelligence and Law enforcement officials in Saudi Arabia, Kuwait and the UAE. The purpose of the trip was to find answers to certain questions we were unable to resolve to our satisfaction and to put officials on notice that cooperation on these issues was critical. We were clear that U.S. interest in these issues would continue.

In these meetings and others held subsequently in the region, we shared information and asked questions. Through the discussions, we identified areas where we could work together. These areas included strengthening the weak regulatory authorities over financial institutions and discussing the possibility for creating new oversight for charities. These proposals were met with assurances of cooperation, but we understood that getting assistance on these issues would be a serious challenge because it represented a change in policies and structures within governments and societies.

Importantly, in efforts to crack down on support for terrorists and terrorist fundraising, we have always made clear the intent of the U.S. government to deal with these issues cooperatively. A key element of our strategy and engagement was to take open, decisive action with host governments against several high impact targets. The designation and blocking of assets of high-profile supporters of terrorist groups could deter others, forcing key nodes of financial support to choose between public exposure of their support for terrorist activity or their good reputation. We believed this approach could also be effective against banks, business, NGOs and other institutions.

We traveled to Saudi Arabia again in January 2000. The purpose was again to communicate that the U.S. wanted to work with Saudi officials jointly in efforts to crack down on support for terrorists and terrorist fundraising. At the time however, we did not have many of the tools necessary to sufficiently back up threats with action; especially, in cases where the target was assessed as intransigent. This is the strategy that has been in place since September 11th as one of the means of deterring and disrupting terrorist financing. The tools Congress and the President have given us since September 11th have enhanced our ability to deliver this message and carry out this strategy.

Post 9-11 Efforts
After the 9-11 attacks, President Bush rallied the international community to unite in the war on terrorism. The international community, including our allies in the Persian Gulf, joined us and have committed to fully cooperating on all fronts against Al-Qaeda and its supporters. On a regular basis, for example, the United States works cooperatively with Saudi authorities on issues relating to the war on terrorism. In some areas, cooperation is routine and systematic; in other areas, especially those touching on aspects of terrorist financing and infrastructure, which touches on all aspects of government, coordination is more complex.

Following up on our previous trips and other U.S. efforts, OFAC visited Saudi Arabia and several other states in the region in December 2001 and January 2002. In Saudi Arabia, we met with an inter-agency delegation to discuss terrorist financing and to explore areas of mutual concern. Specifically, we discussed some possible joint U.S.-Saudi public actions to deny individuals and entities we suspected were supporting terrorism access to international financial markets and to prevent U.S. and Saudi citizens from having dealings with them. We also discussed Saudi efforts to strengthen regulatory oversight of charities and other charitable fundraisers, and steps taken by the Saudi Arabian Monetary Authority (SAMA) to tighten-up banking controls and improve compliance efforts.

In addition, we held meetings with a small group of private Saudi citizens and leaders of the Jeddah Chamber of Commerce (JCCI). The purpose was to explore the charitable giving practices amongst its membership and encourage actions that would ensure that charitable funds are not ultimately channeled to terrorist activity. Later in January 2002, the JCCI announced that a task force would be set up to develop a comprehensive financial and administrative system for the nation's charities.

On March 11, 2002, Treasury Secretary O'Neill and Saudi authorities announced the joint designation of the Somalia and Bosnia-Herzegovina offices of the Al Haramain Foundation, a Saudi-based NGO with offices throughout the world. In addition to on-going law enforcement and intelligence cooperation, this effort marked an expansion of U.S.-Saudi cooperative efforts to act against the terrorist support networks. Based on evidence that these two branch offices were providing support to Al-Qaeda, these entities were forwarded to the UN Sanctions Committee for inclusion under the UNSCR 1333/1390 list.

In May 2002, an OFAC delegation returned to Saudi Arabia to continue the on-going dialogue on issues related to terrorist finance and infrastructure. During this trip, we were informed that the Saudi Government planned to significantly enhance its oversight of charitable organizations to prevent their exploitation by supporters of terrorism. Several months later, on September 6, 2002, the United States acted again with Saudi Arabia and jointly referred to the UN Sanctions Committee Wa'el Hamza Julaidan, an Al-Qaeda co-founder who was a leader of several terrorist-affiliated NGOs.

In October 2002, Saudi authorities announced that a full review was conducted of its charitable organizations and issued new guidelines, including one which mandates reporting to the Saudi Foreign Ministry of all charitable activities outside of Saudi Arabia. Shortly thereafter, on December 3, 2002, Saudi authorities publicly announced the establishment of a High Commission for oversight of all charities. Saudi authorities also reported that a process was being developed to establish operational procedures to track all donations to and from charities.

In addition to these actions, SAMA enhanced its scrutiny of the financial system. As part of this effort, in February 2003, SAMA reported that it had launched a program to train judges and investigators on legal aspects of terrorist financing and money laundering, international requirements for financial secrecy, and methods followed by criminals to exchange information.

Effect of May 12, 2003 Riyadh Attacks
On May 12, 2003, homicide bombers affiliated with Al-Qaeda struck three residential compounds in Riyadh, Saudi Arabia, killing thirty-four including nine Americans. Saudi authorities responded with new resolve in fighting the war on terrorism and carried out a number of actions to capture, kill or arrest suspected terrorists operating in Saudi Arabia.

Marking a recognition of the seriousness of the challenges on terrorist finance and infrastructure issues, Saudi authorities announced that charitable organizations would no longer be authorized to provide funds outside of Saudi Arabia other than through highly-controlled and government supervised channels. Additionally, Saudi authorities announced that Al Haramain was closing operations in as many as ten countries outside Saudi Arabia. The U.S. continues to monitor the status of these announced efforts and to express our critical interest in cooperating to maximize possibilities for effectiveness.

In June 2003, Saudi authorities announced that SAMA distributed a circular to all banks and financial institutions in Saudi Arabia requiring the full and immediate implementation of nine new policies and procedures applicable to charitable and welfare institutions. The new rules include requirements that all accounts of a single organization be consolidated into one account, that depositors provide banks with sufficiently verifiable identification, and that cash withdrawals be strictly prohibited.

To implement these new rules, SAMA reported that it intends to verify compliance through on-site inspections by SAMA officials, receipt of regular compliance reports, and certification by external auditors. The new rules take into account the Saudi Banking Control Law, SAMA's regulations, the Financial Action Task Force (FATF) 40 Recommendations, the FATF 8 Special Recommendations on Terrorist Financing, and applicable UN Security Council resolutions.

The United States supports all efforts reported by Saudi authorities to improve efforts to prevent the flow of charitable funds to terrorist activity. Joint efforts, including the designation of senior Al-Qaeda leadership based in Saudi Arabia like Wael Hamza Julaidan, demonstrate the willingness of Saudi authorities to cooperate on high impact financing and infrastructure targets. These actions by Saudi authorities present the U.S. with opportunities to cooperate in improving, verifying, and evaluating progress. We must continue to engage Saudi authorities in areas where we believe improvements can be made, and continue to demonstrate that we are steadfast in our determination to eliminate the threat posed by the terrorist networks.

As efforts to improve oversight of charities continue, we believe we should seek to cooperate closely in three key areas: (1)—programmatic: (2) personnel; and (3) financial. Specifically, it is critical that we continue to follow up with Saudi authorities to measure whether 1) the true goals and objectives of charities are what they purport to be; 2) whether leadership and staff are appropriately vetted and not committed to any dual-purposes; and 3) whether the means that are used to raise and move funds are transparent.

Additionally, we must continue our dialogue with wealthy individuals, families and merchants to ensure that they are taking all necessary precautions to prevent charitable donations from supporting terrorist activity. In instances where we have strong reason to believe that some elements are not doing enough, we must pursue more stringent measures, which we believe, may force others to become more vigilant in ensuring that funds are not provided for terrorist activity. Looking forward, Saudi Arabia and other important partners continue to indicate their willingness to cooperate in joint efforts, and we remain committed to ensuring that maximum efforts are made to achieve tangible results.

Multilateral Actions Against Al-Qaeda and other Terrorist Infrastructure
Reflecting the broad range of mechanisms by which terrorist groups, particularly Al-Qaeda, receive financial and other material support, OFAC has effectively implemented the President's designation authority against a variety of targets. These range from using targeted economic sanctions to disrupt the terrorist financing operations of an international "hawala" network as well as a more traditional banking network, to disrupting the activities of several key NGOs in supplying financing and other services to Al-Qaeda. Information available to the US Government indicates that these actions have disrupted Al-Qaeda's support network and OFAC continues its efforts to plan, prepare and implement actions, which will impact on the ability of terrorists and their networks to provide material, financial and logistical support for future terrorist strikes. For examples of some of these actions, please see Appendix 1.

Due to the transnational nature of the terrorist infrastructure, support and cooperation with our allies is a critical part of making U.S. designation actions successful. By developing and establishing authorities and procedures for entities associated with Al-Qaeda and the Taliban to be submitted to the UN, we have begun to institutionalize on a global scale the importance of sanctions as a critical tool against the terrorist support networks. We continue to work with our allies in making designations against Al-Qaeda's infrastructure that may be notified to the UN.

Towards a Strategic Effort and "Key Nodes" Approach
Over the next six to twelve months, OFAC is seeking to significantly expand its efforts and the impact of the implementation of the President's authorities under E.O. 13224 by adopting a more systematic approach to evaluating the activities of major terrorist organizations in various regions. This approach will focus on identifying "key nodes" that sustain the abilities of terrorist organizations to remain operational, despite successful actions by the U.S. and its allies to capture, kill and arrest terrorist cell members, leaders and operational planners.

In furtherance of this end, OFAC initiated a collaborative effort with the Department of Defense to develop information and strategies against terrorist financing and infrastructure. Before OFAC's secure facility was operational, DOD agencies to include the Office of Naval Intelligence (ONI), in addition to the Financial Crimes Enforcement Network (FINCEN), generously provided space and support to OFAC personnel that was critical to OFAC efforts immediately following the 9-11 attacks. Since this time, OFAC staff have continued liaison relationships with several DOD agencies and combatant commands. As a result of this effort, OFAC has gained wider access to information and expertise critical in carrying out the President's authorities under EO 13224.

Specifically, in October 2002, OFAC began a joint project with the U.S. Pacific Command (USPACOM) and other DOD elements that identified terrorist support networks in Southeast Asia and selected key nodes, or priority targets, in these networks. The project's geographic scope included four countries — Indonesia, the Philippines, Malaysia and Singapore — and eight terrorist or Islamic extremist groups. The project focused special attention on Jemaa Islamiyah (JI), the Abu Sayyaf Group (ASG), and the Moro Islamic Liberation Front (MILF), because of their relative importance in the region and threat to U.S. interests.

For JI, which subsequently carried out the Bali bombings and has strong ties to Al-Qaeda, the project identified the key leaders, fundraisers, businessmen, recruiters, companies, charities, mosques, and schools that were part of its support network. Thus far, we have imposed sanctions against two of these key nodes, and are coordinating action against several others.

This process is the model that OFAC is seeking to continue and expand in collaborative efforts with DOD agencies including ONI and the combatant commands. Next week, I will be visiting USEUCOM headquarters and meeting with the Chief of Staff, to lay the groundwork to continue a joint project including USEUCOM and OFAC Officers. We also hope to begin projects with the Central (USCENTCOM) and Southern (USSOUTHCOM) Commands shortly thereafter. Working with DOD Commands and other DOD agencies provides OFAC and its DOD partners a force multiplier that brings together a variety of counterterrorism tools and resources to enhance opportunities for future efforts.

Taking a regional approach along with the various command's areas of responsibility, the effort will seek to identify and isolate key nodes in the transnational terrorist support infrastructure in the respective areas of responsibility. This approach seeks to provide the opportunity to cripple an entire organization at one time through OFAC's implementation of the President's authority in coordination with possible actions of other U.S. departments and agencies and in cooperation with our allies.

We have already taken steps to implement this approach in some regions. OFAC analysts are currently working with DOD agencies, including analysts from the Office of Naval Intelligence (ONI), to fully identify the terrorism support infrastructure in the Horn of Africa. In this region, shipping and related drug smuggling activities appear to be strengthening the terrorist networks in this area. Working with ONI provides OFAC the opportunity to work with analysts with unique expertise in areas otherwise less accessible to OFAC.

In the Southern Command area of responsibility, Narco-Terrorists in Colombia are one of the major targets. On October 31, 2001, three Colombian guerrilla-terrorist organizations that had previously been determined to be Foreign Terrorist Organizations the FARC (Revolutionary Armed Forces of Colombia), the AUC (United Self-Defense Forces of Colombia) and the ELN (National Liberation Army) – were added to the list of global terrorists under E.O. 13224. On June 1 of this year, President Bush named two of those organizations – the FARC and the AUC as foreign drug kingpins under authority of the Foreign Narcotics Kingpin Designation Act, thus, effectively recognizing them as narco-terrorists.

Although the structure, goals, and international ties of these groups are significantly different from those of the Islamic extremist terrorist organizations linked to Al-Qaeda and Hamas, these Colombian narco-terrorist organizations are still dependent upon cash or other media of exchange, such as drugs-for-guns, to sustain their guerrilla and paramilitary forces. Thus, although their key nodes may be more difficult to isolate in a meaningful sense for the effective application of OFAC's economic sanctions, they are not immune. We expect that some aspects of these organizations and their support structures will be found to be susceptible to OFAC actions.

For a description of the graphical representations of a key nodes approach that could be applicable to a terrorist support network in any region, please see Appendix 2.

Summary

The funds necessary for a terrorist organization to carry out an attack often are minimal, but the support infrastructure critical for indoctrination, recruitment, training, logistical support, the dissemination of propaganda and other material support requires substantial funding. The President's powers under IEEPA, E.O. 13224, as well as other legislation provide the United States with authorities that are critical to attacking the unusual and extraordinary threats posed by the transnational terrorist support networks. OFAC's effectiveness in implementing these authorities requires strong coordination with other U.S. departments and agencies and support from U.S. allies.

Terrorist organizations including Al-Qaeda, Egyptian Islamic Jihad, Jemaa Islamiyah, Al-Ittihad Al-Islamiyya, Hamas, Hizballah and others rely on their infrastructure for support and to shield their activities from scrutiny. The secretive nature of their activities and their frequent reliance on charitable, humanitarian, educational and religious cover are vulnerabilities OFAC can exploit by making designations under E.O. 13224. Decisive action against high impact targets deters others, forcing key nodes of financial support to choose between public exposure of support for terrorist activity or tarnishing their reputation, to the detriment of their business and commercial interests.

Looking forward, OFAC seeks to continue coordinating with other U.S. agencies as efforts are expanded to impede the activities of terrorist organizations. By duplicating the approach to Southeast Asia in coordination with USPACOM, we plan to identify and isolate key nodes in the transnational terrorist support infrastructure through a regional approach reflecting the areas of responsibility of the military commands. This approach seeks to enhance the coordination of OFAC's actions with those of other U.S. departments and agencies and in cooperation with allies.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
2003-7-30-17-32-11-17350

The Honorable John McCain Chairman, Committee, Science and Transportation United States Senate

July 30, 2003

The Honorable John McCain
Chairman, Committee on Commerce, Science and Transportation
United States Senate
253 Senate Russell Office Building
Washington, DC 20510

Dear Chairman McCain:

We are writing to express our strong support for legislation to make permanent the moratorium on Internet access taxes, regardless of the speed of that access, and on multiple and discriminatory taxes on electronic commerce. Following the House Judiciary Committee's swift adoption of H.R. 49 last week, we encourage you to take similar action so the President can sign legislation before the current moratorium expires on November 1 of this year.

The Internet is an innovative force that opens up the vast potential economic and social benefits of e-commerce and enables such applications as distance learning, telemedicine, e-business, e-manufacturing, e-government, and precision farming. Government must not slow the rollout of Internet services by creating administrative barriers or imposing new access taxes. Nor should government stifle e-commerce through multiple or discriminatory taxes.

We look forward to working with you again on this important issue. If you should have any further questions or concerns, please feel free to contact us or Brenda Becker, Assistant Secretary for Legislative and Intergovernmental Affairs, Department of Commerce, at (202) 482-3663, or Pam Olson, Assistant Secretary for Tax Policy, Department of the Treasury, at (202) 622-0050.

Sincerely,

Donald L. Evans   John W. Snow

cc: Senator Ernest Hollings
Senator George Allen
Senator Ron Wyden