Department of the Treasury

PRESS RELEASES

The following numbers were not used:

JS-628, 632, 661, 663 and 677

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 1, 2003
JS-626

Presentation of Terrorism Risk Insurance Program Executive Director Jeffrey Bragg to the Ohio Insurance Institute Columbus, OH

Slide 1: Introduction

Slide 2:

Good morning and thank you for the opportunity to speak to you this morning on Treasury's progress and plans for implementing the Terrorism Risk Insurance Act of 2002, otherwise referred to as TRIA.

On November 26, 2002, President Bush signed TRIA into law.

With an estimated $40B in insured loss as a result of the events of 9/11 the market for terrorism coverage became severely disrupted.

However in addition to wanting to address Insurance industry disruptions, the Congress and the President recognized that such wide spread dislocations in insurance markets also had a negative impact on business' ability to finance economic activity and recovery.

TRIA was therefore enacted to stabilize insurance protection by assuring the availability of protection as well as to stabilize the overall economy.

Slide 3:

TRIA effectively places the Federal Government temporarily in the terrorism risk reinsurance business:

• Providing coverage for commercial lines P&C losses including workers' compensation.

• Coverage is triggered when the Secretary of the Treasury in consultation with the Secretary of State and the Attorney General certifies that an act of terrorism carried out by on behalf of a foreign interest has occurred:

• This terrorism generated loss must be greater than $5M

And the event must have taken place in the US, or a US foreign mission, or on a US air carrier or vessel.

Slide 4:

One of the first things that had to be defined under the act was what constitutes a P&C insurer.

Although this was task more difficult than it first appeared to be "Insurer" for purposes of the act is any entity that is:

Licensed or admitted for primary or excess insurance in any state

A surplus lines carrier on the quarterly NAIC listing of alien insurers

Approved by a federal agency in connection with maritime, energy, or aviation activity

A State residual market or workers compensation fund

Altogether well over 2000 insurance companies are participating in the program.

But understandably programs with current federal exposure like the National Flood Insurance program are not included.

Also insurance products including assumed reinsurance, health and life insurance and for now group life insurance are excluded from the program.

Slide 5:

Like any program there are restrictions.

• Deductibles increase over the 3 year term of the program and are expressed as a percent of an insurer's direct earned premium.

• The Federal Governments share under the program is equal to 90% of that portion of insured losses that exceed the insurer deductible.

• While there is a cap on total insured losses: if total losses exceed the cap Congress will determine the procedures for and source of payments for those excess losses.

• The program is scheduled to end on December 31, 2005

(Cite Riot Reinsurance Crime Insurance experience)

Slide 6:

There are provisions under the act whereby the Secretary can recoup certain government payments

Mandatory recoupment is triggered whenever there is a loss and the insurance industry paid losses are less than that year's industry retention.

The annual industry retention is equal to the lesser of a fixed dollar amount or the aggregate insured losses which is defined as all losses associated with an act of terrorism that are within an insurer's deductible and the 10% of insured loss quota share.

Under mandatory recoupment The Secretary will establish Terrorism Loss Risk Sharing Premiums of up to a 3% surcharge on all commercial policy premiums

In addition The Secretary can depending on economic conditions impose an additional discretionary recoupment program whereby additional surcharges on insurance premiums can be collected.

Slide 7:

To illustrate lets assume a loss covered by the program during the third year of the program of $20B. This Loss is greater than the insurance industry's maximum aggregate retention that year of $15B.

Further assume that 100 insurance companies were exposed to that loss and that their collective direct earned premiums totaled $20B.

The third year deductible of 15% equals $3B for these 100 companies and their 10% quota share equals another $1.7B making the insurer's share of the total paid losses for the companies involved $4.7B

Under this example Treasury would require all companies covered under the program to impose up to a 3% premium surcharge on all policy holders until an additional $10.3B had been recouped. This spreading of the risk allows The Treasury Department to recover government losses paid up to the insurance industry's maximum aggregate retention.

Additionally depending on economic considerations the Secretary of the Treasury has discretionary authority to impose additional recoupment surcharges and could recoup up to the entire $20B loss.

Slide 8:

The Terrorism Risk Insurance Program or T.R.I.P. is itself under Treasury's Department for Domestic Finance (headed by Under Secretary Peter Fisher) and the Office of Financial Institutions (headed by Assistant Secretary Wayne Abernathy).

TRIP's responsibilities include all of the operational functions necessary to effectively implement and manage the program, including all claims management and processing functions, as well as all auditing functions

TRIP is in essence the insurance company created by the new law.

However 2 additional Treasury offices play an important part in the program.

Treasury's Office of Economic Policy will be conducting studies associated with coverage issue under TRIA and the overall effectiveness of the program.

The office of Financial Institutions Policy will take the lead in promulgating rules and regulations.

TRIP will work closely with both offices as we coordinate our activities

Slide 9:

Already substantial progress has been made in implementing the program

The Office of Financial Institutions Policy has been extremely active in implementing the regulations necessary to support the new act

- They have issued
- 4 interim guidance notices
- 2 interim final rules
- 1 notice of proposed rulemaking
- A final rule.

Slide 10:

The final rule published in the federal register on July 11 set forth key definitions

that Treasury will use in implementing the program.

Among other things this rule addresses:

- Guidance on the Lines of Insurance covered under the act
- Which entities are eligible for participation
- Control and affiliation issues

The Insurance industry generally and the OII specifically have been very helpful in representing your views to the Treasury Department on these and other issues. However I urge all of you to review these regulations closely to make certain you are in compliance with the act and can take advantage of this important federal protection.

Slide 11:

One of the most debated issues in the new regulations was the definitions of affiliate and what constitutes control. The issue is important when it comes to determining the appropriate deductible for any affiliated insurance group.

Conclusive Control Exists

• if an insurer has power to vote 25% or more of any class of voting securities of the other insurer.

• if an insurer controls the election of a majority of the Directors or Trustees of the other insurer.

Presumptive Control Exists

• If the Secretary of the Treasury determines that an insurer exercises a controlling influence over another insurer.

• In determining presumptive control The Secretary will consider approximately 11 other factors outlined in the regulations the presence of any 2 leading to a determination of presumptive control

Slide 12:

We can however gain some comfort in the fact that these rules envision that there will be some confusion over issues like the definition of an insurer or what constitutes controlling interest.

We have received many questions on these and many other topics. So if after reviewing these regulations in some detail you still have questions you may request an interpretation of the regulations as they apply to your specific situation.

In submitting your request it is not necessary to compose a lengthy dissertation and we will make every effort to respond to your issues in a timely manner

Slide 13:

The ink is not yet dry on there final rules and we are already working to finalize a second set of rules which will address such issues as:

- Make available requirements
- Disclosure requirements
- State residual markets

Unfortunately this process is really never ending. Thousands of pages of rules,

definitions, procedures, and regulations will be drafted, debated, and finalized over the next 3 years. And believe me there are still many issues to deal with.

Slide 14:

Even though much has been accomplished, considerable, considerable work remains. Many in the industry have expressed concerns over such program issues as:

- Adverse selection
- Continued lack of reinsurance availability
- Huge exposures particularly in worker's compensation
- Availability/Affordability

In fact most of these issues have been volatile at various and numerous times in the past. And TRIA was passed in part to address them. These issues are in fact characteristic of other past Federal Insurance programs.

I believe that over time the free market will help solve these problems while TRIA contributes over time to help build capacity and stabilize the market.

Slide 15:

Right now, what keeps me awake at night are operational issues. We have a huge amount of work ahead of us and not very much time to accomplish it.

In addition to having a tremendous amount to accomplish to get our program up and running we have also had to put emergency procedures in place so that should there be a loss before we are fully operational we will be able to respond to that loss.

In essence this means working on a duel approach to make certain we are prepared.

So as we go about implementing all of issues you see before you and more let me describe the last bullet on the slide in more detail.

Through out my career both in the private sector (with PMSC, IMSG and REM) and with my government service I have been a strong advocate of outsourcing functions that can be better handled by others with more experience and expertise.

I have also where possible created partnerships between the government and private sector insurance industry which draws on the strengths of both entities to create a more successful program. That was why we created the Write Your Own program for the National Flood Insurance Program many years ago.

Therefore it should come as no surprise that in implementing this program we will not be creating a huge infrastructure.

Rather we will establish a virtual company that permits us to form new partnerships with the private insurance sector, harnessing that Insurance Industry's talents and skills to make this an effective streamlined operation.

Slide 16

In addition to the overall operational issues we just discussed we also know there are many specific claims issues to deal with including the speed with which we will be able to reimburse insures all the way down the list to the mechanisms by which we will audit our own payments.

Hopefully it will come as good news to you that we intend that claims made under the program will be processed and paid in manner highly consistent with what you now experience with the reinsurance industry.

In implementing all of the requirements necessary to pass our own audits, as well as the as sure as you are sitting here expected GAO audits, we will be mindful of current insurance industry practices standards and needs. We will do our best to meet those needs and protect the people's assets without overreaching.

Conclusion:

Ladies and gentlemen like all of you I sincerely hope and pray that this program will never be tested. But with your help we can at least try to be prepared should our nation ever again be required to call upon our industry to respond to the needs of our insured's

Once again I look forward to working with you on this new venture and in closing thank you for future support and your time today

Related Documents:

- Terrorism Risk Insurance Program Slides

Terrorism Risk Insurance Program

Jeffrey S. Bragg
Executive Director

Terrorism Risk Insurance Program

Purpose

- Address Insurance Market Disruptions
- Ensure Availability and Affordability of Commercial P&C Terrorism Coverage
- Provide Transition Period
- Stabilize and Build Capacity in Private Market
- Strengthen Overall Economy

Terrorism Risk Insurance Program

Summary of Program

Certifies Act of Foreign Terrorism

Resulting in Damage > 5M

IN

United States

U.S. Missions

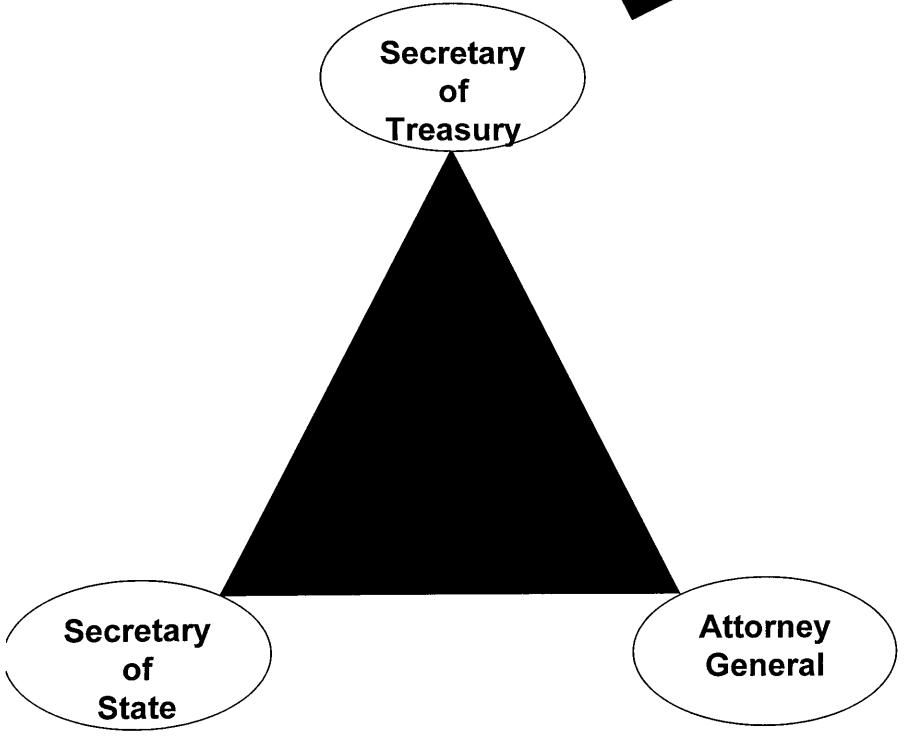
U.S. Air Carriers

U.S. Vessels

FOR

Commercial Lines P & C

Workers Compensation



Terrorism Risk Insurance Program

Property & Casualty Insurance

- Means commercial lines including excess, workers' compensation, and surety
  - NAIC Annual statement of Premiums + Losses (Statutory Page 14)

- Does not mean:
  - Federal crop insurance
  - Private mortgage insurance
  - Financial guaranty insurance
  - Medical malpractice insurance
  - Health or life insurance, including group life
  - Flood insurance
  - Reinsurance or retrocessional insurance

Terrorism Risk Insurance Program

Restrictions

- **Temporary Program**
  Expires 2005

- **Company Deductible**

2003	7%	+ 10% Insured Loss (after the deductible)
2004	10%	
2005	15%	

- **$100 Billion Annual Cap on Insured Losses**

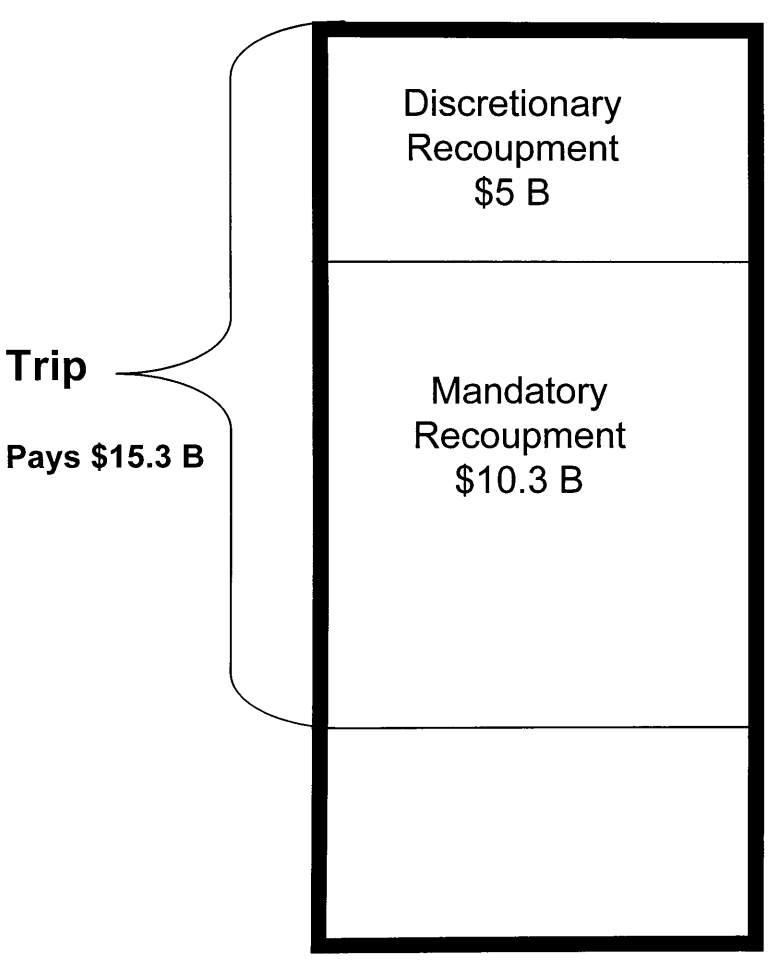
Terrorism Risk Insurance Program

Recoupment

- The Secretary will establish "Terrorism Loss Risk-Spreading Premium" (TLRS Premiums) to recoup federal TRIP assistance.
- TLRS Premiums will be imposed on policies, collected by insures, and remitted to the Treasury.
- Mandatory TLRS Premiums up to 3% of policy premiums for any policy.
- The Secretary may make adjustments for:
  - Urban & Smaller Commercial & Rural Areas, and
  - Different lines of insurance.
- Discretionary Recoupment

Terrorism Risk Insurance Program

Recoupment Example



$20 B Insured Loss

$15 B 3rd Year Industry Aggregate Retention

$4.7 B Paid by 100 companies

100 Insurers Impacted

DEP 100 Insures = $20 B

15% deductible = $3 B

10% quota share = $1.7 B

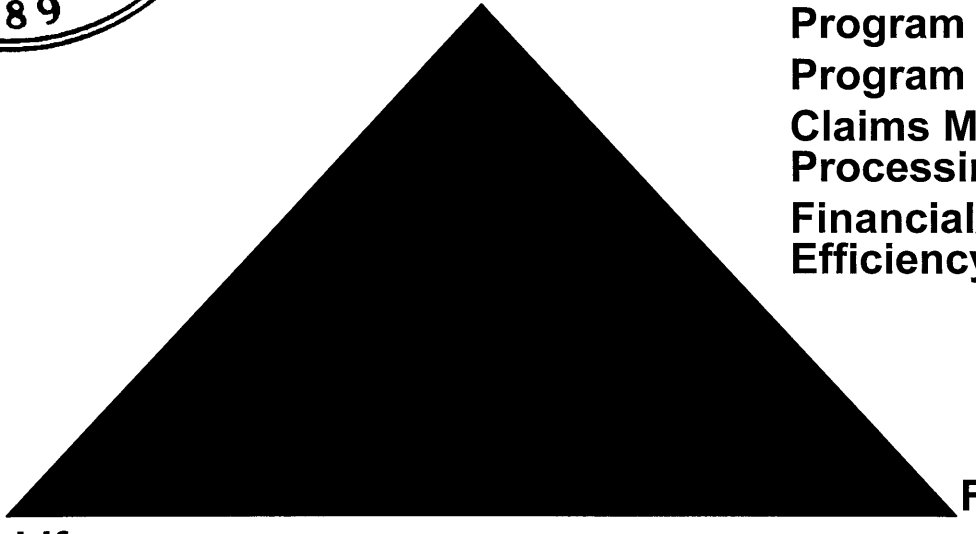
100 Companies Pay $4.7 B

Terrorism Risk Insurance Program

Treasury Offices

T.R.I.P.

- Implementation
- Program Management
- Program Operations
- Claims Management/ Processing
- Financial/Operational Efficiency



O.E.P

- Group Life
- Individual Life
- Personal Lines
- 2005 make available extension

F.I.P

- Interim Rules
- Program
- Regulations

Terrorism Risk Insurance Program

Progress To Date

- 4 Interim Guidance Notices
- 2 Interim Final Rule
- Proposed Rule
  - State residual markets
  - State Worker's Comp Fund

➔ Hire Executive Director

Terrorism Risk Insurance Program

First Final Rule

- Published July 11, 2003
- Provides key definitions, such as "Act of Terrorism," "Insurer," and "Affiliate"
- Identifies lines of Commercial Property & Casualty Insurance included in the Program
- Addresses Direct Earned Premium and calculation between personal and commercial lines
- Establishes process for insurers to request interpretations from TRIP

Terrorism Risk Insurance Program

Final Rule: Definition of "Affiliate" & "Control"

Section 102(6) of the Act defines an "insurer" to include "any affiliate thereof."

"Affiliate" means "with respect to any insurer, an entity that controls, is controlled by or is under common control with the insurer."

What is Control?

"Control" exists:

- **(1) if an insurer directly or indirectly or acting through 1 or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other insurer (this is conclusive of control);**

- **(2) if an insurer controls in any manner the election of a majority of the directors or trustees of the other insurer (this is conclusive of control);**

- **(3) if the Secretary determines, after notice and opportunity for hearing, that the insurer directly or indirectly exercises *a controlling influence* over the management or policies of the other insurer (this is presumptive of control).**

Terrorism Risk Insurance Program

Final Rule: Requests

- Insurers can request a determination of "controlling influence" of affiliates
  - Written submission to TRIP
  - Treasury can ask for more information or for an informal oral hearing
  - Determination generally within 60 days

- Insurers can request a general interpretation of statute
  - Written submission to TRIP

Terrorism Risk Insurance Program

Pending Rulemaking

- Treasury is in the process of finalizing an interim final rule and a notice of proposed rule, which will next address
  - Make available requirements
  - Disclosure requirements
  - State residual market mechanisms

Terrorism Risk Insurance Program

Program Issues

- Adverse selection
- Availability/Afordability
- Huge Exposure (ESP Workers Compensation)
- State Exemptions

Terrorism Risk Insurance Program

Operational Issues

- Recruit/Hire TRIP Staff
- Establish Emergency Implementation Plan
- Establish/Implement Claims Procedures
- Establish Audit/Enforcement Procedures
- Policy Surcharge Recoupment Procedures
- Final Rules
- Establish "Virtual" Company

Terrorism Risk Insurance Program

Claims Issues

- Speed with which TRIP will act on a request for reimbursement.
- Payment of allocated loss adjustment expenses.
- Level of documentation required to support a claim.
- Unique data elements required in reporting.
- Selection of vendor to administer reimbursement process.
- Treasury selection of Audit Vender
- Partial Payments

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 1, 2003
JS-627

Treasury And IRS Issue Final Regulations For Golden Parachute Payments

Today, the Treasury Department and the IRS issued final regulations for "golden parachute payments." Treasury and IRS also issued a new revenue procedure for valuing stock options that are treated as golden parachute payments.

Under the Internal Revenue Code, a company cannot deduct "excess" golden parachute payments, and an executive has to pay a 20-percent excise tax on the payments. A golden parachute payment is a payment made in connection with a change in ownership or control of a company.

The final regulations generally follow the proposed regulations that were published in February of 2002. As under the proposed regulations, stock options granted or vested as part of a change of control are parachute payments. The new revenue procedure revises an earlier valuation method for stock options. The valuation method continues to allow the use of Black-Scholes and certain other option valuation methods, but it provides new flexibility to make certain adjustments for early termination of employment or changes in volatility of stock price.

The final regulations are effective for payments made in connection with a change of ownership or control occurring on or after January 1, 2004. Taxpayers cannot rely on the 2002 proposed regulations after that date.

The final regulations and the revenue procedure are attached.

-30-

Related Documents:

- Final Regulations
- Revenue Procedures

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1

[TD 9083]

RIN: 1545-AH49

Golden Parachute Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to golden parachute payments under section 280G of the Internal Revenue Code. These regulations incorporate changes and clarifications to reflect comments received concerning the proposed regulations primarily concerning the small corporation exemption, prepayment of the excise tax, and the definition of change in ownership or control.

DATES: Effective Date: August 4, 2003. These regulations apply to any payment that is contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

Comments on the collection of information in §1.280G-1, Q/A-7(a) should be received by October 3, 2003.

ADDRESSES: Comments on the collection 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.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Erinn Madden at (202) 622-6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The collection of information in this final rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1851.

The collection of information in this regulation is in §1.280G-1, Q/A-7(a). This information is a brief description of all material facts concerning all payments which would be parachute payments (but for §1.280G-1, Q/A-6). This information may be used by certain corporations with no readily tradeable stock (assuming certain shareholder approval requirements are also met) to determine if the payments to a disqualified individual are exempt from the definition of parachute payments. The collection of information is voluntary. The likely respondents are business or other for-profit institutions.

Comments on the collection 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 collection of information in §1.280G-1, Q/A-7(a) should be received by October 3, 2003. Comments are specifically requested

concerning:

Whether the collection[s] of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the 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 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 service to provide information.

Estimated total annual reporting and/or recordkeeping burden: 12,000 hours.

Estimated average annual burden hours per respondent: 15 hours.

Estimated number of respondents and/or recordkeepers: 800

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 amendments to 26 CFR part 1 under section 280G of the Internal Revenue Code (Code). Sections 280G and 4999 of the Code were added to the Code by section 67 of the Deficit Reduction Act of 1984, Public Law 98-369 (98 Stat. 585). Section 280G was amended by section 1804(j) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2807), section 1018(d) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647 (102 Stat. 3581) and section 1421 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755).

Section 280G denies a deduction to a corporation for any excess parachute payment. Section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment. Related provisions include section 275(a)(6), which denies the recipient a deduction for the section 4999 excise tax, and section 3121(v)(2)(A), which relates to the Federal Insurance Contributions Act.

On February 20, 2002, a notice of proposed rulemaking (REG-209114-90, 2002-2 I.R.B. 576), was published in the **Federal Register** at 67 FR 7630 (the 2002 proposed regulations) and corrected in the **Federal Register** at 67 FR 42210 on June 21, 2002. No hearing was requested or held. The IRS received written and electronic comments responding to the notice of proposed rulemaking. After consideration of the comments, the 2002 proposed regulations are adopted as amended by this Treasury decision. The

significant revisions are discussed below.

Explanation of Provisions and Summary of Comments

Overview

Section 280G(b)(2)(A) defines a parachute payment as any payment that meets all of the following four conditions: (a) the payment is in the nature of compensation; (b) the payment is to, or for the benefit of, a disqualified individual; (c) the payment is contingent on a change in the ownership of a corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation (a change in ownership or control); and (d) the payment has (together with other payments described in (a), (b), and (c) of this paragraph with respect to the same individual) an aggregate present value of at least 3 times the individual's base amount. Section 280G(b)(2)(B) provides that the term parachute payment also includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual if the payment is pursuant to an agreement that violates any generally enforced securities laws or regulations (securities violation parachute payment).

Section 280G(b)(1) defines the term excess parachute payment as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to a parachute payment is the amount that bears the same ratio to the base amount as the present value of the parachute payment bears to the aggregate present value of all such payments to the same disqualified individual.

Generally, excess parachute payments may be reduced by certain amounts of

reasonable compensation. Section 280G(b)(4)(B) provides that, except in the case of securities violation parachute payments, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Such reasonable compensation is first offset against the portion of the base amount allocated to the payment.

Exempt Payments

Section 280G specifically exempts from the definition of the term parachute payment several types of payments that would otherwise constitute parachute payments. Deductions for payments exempt from the definition of parachute payment are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of section 280G(b)(2)(A)(ii).

1. Tax-Exempt Entities

Q/A-6 of the 2002 proposed regulations provides that a payment with respect to a tax-exempt entity that would otherwise constitute a parachute payment is exempt from the definition of the term parachute payment if certain conditions are satisfied. First, the payment must be made by a corporation undergoing a change in ownership or control that is a tax-exempt organization. As defined in the 2002 proposed regulations, a tax-exempt organization is any organization described in section 501(c) that is subject to any express statutory prohibition against inurement of net earnings to the benefit of any

private shareholder or individual, an organization described in sections 501(c)(1) or 501(c)(21), any religious or apostolic organization described in section 501(d), or any qualified tuition program described in section 529. Second, the organization must meet the definition of tax-exempt organization, as defined in the 2002 proposed regulations, both immediately before and immediately after the change in ownership or control.

One commentator requested the elimination of the requirement that the payment must be made by a tax-exempt organization. Instead, the commentator suggested that the regulations require only that the payment be approved by the tax-exempt organization. The exemption included in Q/A-6 of the 2002 proposed regulations for certain tax-exempt entities described in section 501(c) is premised on the fact that those entities are subject to a statutory prohibition on private inurement. Requiring merely the approval of a tax-exempt organization would allow corporations not subject to the inurement prohibition to make the payments and, thus, to avoid the application of section 280G. Thus, these regulations retain the requirements contained in the 2002 proposed regulations.

2. Small Corporation Exemption

Under section 280G and the 2002 proposed regulations, the term parachute payment does not include any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) was a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof). See also, Q/A-6(a)(1).

Commentators indicated that the 2002 proposed regulations do not clearly

address whether a corporation that does not elect to be treated as an S Corporation, but could make the election (because aside from the election the corporation otherwise meets the requirements to be treated as an S corporation), may use the exemption under Q/A-6(a)(1). These regulations clarify that a corporation that could elect to be treated as an S Corporation under the Code, but does not do so, may nevertheless use the exemption of Q/A-6(a)(1) for any payments to a disqualified individual.

In addition, commentators recommended that the final regulations provide that a corporation domiciled outside the United States can qualify for both the small business corporation exception and the shareholder approval exception. With respect to the small business corporation exception, Treasury and the IRS do not have the authority to expand this exception to include foreign corporations. Section 280G(b)(5)(A)(i) refers to "a small business corporation (as defined in section 1361(b) but without regard to paragraph (1)(C) thereof)." A small business corporation as defined in section 1361(b) must be a domestic corporation, and section 1361(b)(1)(C) merely addresses the existence of a nonresident alien as a shareholder. It is clear from the statute that the small business corporation exception cannot apply to a foreign corporation.

On the other hand, Treasury and the IRS believe that a foreign corporation may qualify for the shareholder approval exception, discussed below, if all of the applicable requirements are satisfied. Because the statute and regulations permit this result, it is not necessary to specify the treatment in the final regulations.

3. Shareholder Approval

Additionally, under section 280G and the 2002 proposed regulations, the term

parachute payment does not include any payment to a disqualified individual with respect to a corporation if (i) immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise, and (ii) certain shareholder approval requirements are met.

Section 280G(b)(5)(B) provides that the shareholder approval requirements are met if two conditions are satisfied. First, the payment is approved by a vote of the persons who owned, immediately before the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation. Second, there is adequate disclosure to shareholders of all material facts concerning all payments which (but for this rule) would be parachute payments with respect to a disqualified individual.

Q/A-7(b) of the 2002 proposed regulations provides rules to determine the shareholders who are entitled to vote. In response to comments, Q/A-7(b)(1) is revised to clarify that only stock that would otherwise be entitled to vote is considered outstanding and is entitled to vote for purposes of Q/A-7(b). Thus, for example, because an individual who only holds options generally would not be entitled to vote, such individual will not be considered to hold outstanding stock entitled to vote for purposes of Q/A-7.

Q/A-7(b)(2) of the 2002 proposed regulations includes a rule of administrative convenience allowing the corporation to identify shareholders eligible to vote for this purpose using the shareholders of record at the time of any vote taken in connection with a transaction or event giving rise to the change in ownership or control within the

three-month period ending on the date of the change in ownership or control.

Several commentators suggested that the final regulations permit corporations to determine the shareholders of record at any time during the three months prior to the change in ownership or control. Other commentators requested that the time be expanded in the final regulations. In response to these comments, these regulations expand this rule to allow corporations to determine the shareholders of record on any day during the six-month period ending on the date of the change in ownership or control, regardless of whether there was a vote on that day.

Q/A-7(b)(4) is revised to clarify that stock held (directly or indirectly) by a disqualified individual who would receive a parachute payment if the shareholder approval requirements of Q/A-7 are not met is not entitled to vote with respect to a payment to be made to any disqualified individual. For example, assume E is a disqualified individual with respect to Corporation X. E's base amount is $100,000, and on a change in ownership or control of X, E will receive contingent payments of $295,000. Corporation X undergoes a change in ownership or control. In determining the persons who are entitled to vote under Q/A-7(b), any stock held by E is considered outstanding and E is entitled to vote. If E would receive contingent payments of $305,000 on the change in ownership or control, any stock held by E is not considered outstanding and is not entitled to vote under Q/A-7 with respect to payments to any disqualified individual.

An entity shareholder is not entitled to vote stock that it holds that is constructively owned by a disqualified person who would receive a parachute payment

if the shareholder approval requirements of Q/A-7 are not met. Additionally, these regulations provide in Q/A-7(b)(4) that if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the requirements of Q/A-7 are not met, such person is not permitted to vote any of the shares held by the entity shareholder. However, the entity shareholder is permitted to authorize another equity interest holder in the entity shareholder to vote the otherwise eligible shares or, in the case of a trust, another person eligible to vote on behalf of the trust. Thus, for example, assume a partner owns one-third of a partnership; the partner is authorized to vote on behalf of the partnership; the partnership owns stock in a corporation; the partner is a disqualified individual with respect to the corporation; and the corporation undergoes a change in ownership or control. Under these circumstances, none of the stock held by the partnership is entitled to vote under Q/A-7. However, the partnership is permitted to appoint an equity interest holder in the entity shareholder (who is not a disqualified individual who would receive parachute payments if the shareholder approval requirements of Q/A-7 are not met) to vote two-thirds of the stock.

More generally, several commentators requested significant revisions to Q/A-7 to reflect certain business practices. The revisions suggested by commentators include, among other things, treating approval of a compensation agreement when the agreement is executed as sufficient for Q/A-7 or deeming shareholders who acquire stock after approval of any compensation agreements to consent to any parachute payments contained in these agreements. While the Treasury Department and IRS

understand that the requirements of Q/A-7 may not coincide with certain business practices, the requirements of Q/A-7 are based on the statutory framework provided by Congress. The golden parachute provisions are intended to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals by discouraging these types of payments. The basic structure of section 280G does not permit any approval or shareholder vote for a publicly traded corporation. The exception for corporations that are not publicly traded is based on a vote of those persons who hold shares immediately before the change in ownership or control after adequate disclosure. The suggested revisions to the shareholder approval requirements are inconsistent with these requirements and, accordingly, no changes are made in these regulations.

Payment of the Excise Tax under section 4999

Q/A-11(c) of the 2002 proposed regulations provided a mechanism to allow a disqualified individual to prepay the excise tax under section 4999 in certain circumstances. Thus, the requirements of section 4999 may be satisfied in the year of the change in ownership or control (or the first year for which a payment contingent on a change in ownership or control is certain to be made) even though the payment is not yet includible in income (or otherwise received).

These regulations continue to allow the prepayment of the excise tax in the year of the change in ownership or control. These regulations also provide that a taxpayer may prepay the excise tax in a later year. For purposes of prepayment, these regulations require the payor and disqualified individual to treat the payment of the

excise tax consistently and require the payor to satisfy its obligations under section 4999. These regulations clarify that the prepayment of the excise tax is based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid. For purposes of determining the present value of the excise tax due, the discount rate is determined in accordance with Q/A-32.

Thus, for example, assume that E is a disqualified individual with respect to Corporation X, that X undergoes a change in ownership or control, and that E receives parachute payments, including a series of annual payments to be made for the next 10 years. Assume further that all other parachute payments to E are made in the year of the change in ownership or control (with payment of the excise tax and compliance by X with section 4999(c)). Under these regulations, if three years after a change in ownership or control, X and E agree that E will prepay the excise tax related to the remaining annual payments, and that X will satisfy its obligations under section 4999(c) related to these payments, E is permitted to prepay the excise tax with respect to the remaining payments.

The 2002 proposed regulations provided that the prepayment of the excise tax would not be available with respect to certain payments, including payments related to health benefits or coverage. Commenters requested that the prepayment option be expanded to include health benefits or coverage. Treasury and the IRS do not consider the available valuation methods sufficient to allow projections of individual payments related to health coverage or health benefits for this purpose. In the event that valuation methods change or there is otherwise greater certainty with respect to the valuation of

such benefits, Treasury and the IRS may consider additional guidance that would make prepayment of the excise tax with respect to such benefits available.

Treatment of Options

Q/A-13 of the 2002 proposed regulations provides that the transfer of an option is treated as a payment when the option becomes substantially vested without regard to whether the option has an ascertainable fair market value under §1.83-7(b) of the regulations. Thus, the vesting of an option is treated as a payment in the nature of compensation for purposes of section 280G. Vested is defined in these regulations as substantially vested within the meaning of §1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c).

The 2002 proposed regulations, and the 1989 proposed regulations, provided that options must be valued under the facts and circumstances of a particular case. Factors relevant to the determination include, but are not limited to: the difference between the option's exercise price and the value of the option property, the probability of the value of the option property increasing or decreasing, and the length of the period during which the option can be exercised.

In coordination with the issuance of the 2002 proposed regulations, the Commissioner issued two revenue procedures under section 280G providing additional guidance on the valuation of options, Rev. Proc. 2002-13, 2002-8 I.R.B. 549, and Rev. Proc. 2002-45, 2002-27 I.R.B. 40. These revenue procedures provide guidance on the use of option valuation methods, and provide that using only the spread between the

exercise price and the value of the option property is not an adequate method for valuing an option. The revenue procedures also provide a safe harbor method of valuation based on a table. Comments received in response to these revenue procedures raised issues related to the difficulty of valuing options in the context of a change in ownership or control, particularly with respect to assumptions regarding the term of the option and the volatility. In coordination with the issuance of these regulations, the IRS is issuing a revenue procedure restating the previous revenue procedures and addressing these comments.

Disqualified Individuals

The 2002 proposed regulations provide that an individual is a disqualified individual if, at any time during the disqualified individual determination period, the individual is an employee or independent contractor of the corporation and is, with respect to the corporation, a shareholder (see Q/A-17), an officer (see Q/A-18), or (3) a highly-compensated individual (see Q/A-19). The 2002 proposed regulations provide that whether an individual is an officer with respect to a corporation is determined based on all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties).

These regulations retain this rule concerning officers. However, under Q/A-18 of these regulations any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may

nevertheless be considered an officer if the facts and circumstances demonstrate that the individual should be considered to be an officer.

Nonvested Payments under Q/A-24

Under Q/A-24(c) of the 2002 proposed regulations, only a portion of certain nonvested payments is treated as contingent on a change in ownership or control. Specifically, Q/A-24(c) applies to a payment that becomes vested as a result of a change in ownership or control to the extent that (i) without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and (ii) the payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

These regulations retain these rules regarding the calculation of the amount of the payment that is considered contingent on a change in ownership or control, with one revision. Under the 2002 proposed regulations, the payment calculation under Q/A-24(c) could not exceed the amount of the accelerated payment. A portion of a payment is contingent on a change in ownership or control if there is accelerated vesting, even if there is no accelerated payment. In that case, the amount attributable to the lapse of the obligation to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. Under these final regulations, the total portion of such payment treated as contingent on the change in ownership or control cannot exceed the

present value of the accelerated payment.

Change in Ownership or Control

A change in ownership or control is defined in Q/A-27, 28, and 29 of the 2002 proposed regulations. Under Q/A-27 of the 2002 proposed regulations, a change in control of a corporation occurs on the date that any one person (or persons acting as a group) acquires ownership or stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the corporation.

Under Q/A-28 of the 2002 proposed regulations, a change in the effective control of a corporation is presumed to occur on the date that either (1) any one person (or more than one person acting as a group) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation, or (2) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

Under Q/A-29 of the 2002 proposed regulations, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person (or more than one person acting as a group) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person) assets from the corporation that have a total gross fair market value equal to or more than one third

of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition.

These regulations generally follow the same approach as the 2002 proposed regulations. Some commenters suggested that these three provisions explicitly address whether more than one change in ownership or control can occur in a single transaction. In response to these comments, these regulations explicitly adopt the "one change" rule that historically has been applied by the IRS. These regulations provide that if a corporation undergoes a change in ownership or control as described in either Q/A-27 or Q/A-29, the other corporation involved in the transaction does not undergo a change in ownership or control.[1] As these regulations apply, in any transaction involving two corporations, if one has a change in ownership or control under Q/A-27 or 29, the other corporation does not also have a change in ownership or control, under either Q/A-27 or 29. Under these regulations, Q/A-28, which relates to effective control, provides that there is no change in effective control of a corporation in a transaction in which the other corporation has a change of control under Q/A-27 or 29.

Commentators also requested that the final regulations define gross fair market value for purposes of Q/A-29. Under Q/A-29 of these regulations, gross fair market value is defined as the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This definition is used throughout these regulations.

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[1] Because Q/A-46 provides that all members of an affiliated group are treated as one corporation, even transactions involving multiple entities generally are treated as only two corporations for purposes of section 280G.

For purposes of determining whether there is a change in ownership or control under Q/A-27 through Q/A-29 of the 2002 proposed regulations, two or more persons may be considered as acting as a group. The 2002 proposed regulations provide that, for purposes of determining whether two or more persons are acting as a group, a person who owns stock in both corporations involved in a transaction (an overlapping shareholder) is treated as acting as a group with respect to the other shareholders in a corporation only to the extent of such person's ownership of stock in that corporation prior to the transaction, and not with respect to his or her ownership in the other corporation. This rule is consistent with the interpretation of the 1989 proposed regulations by the IRS.

Commentators suggested different alternatives to the overlapping shareholder rule of Q/A-27 through Q/A-29 of the 2002 proposed regulations. One commentator suggested eliminating the overlapping shareholder rule and instead relying on the presumption of Q/A-28 for all transactions. Under this approach it would be possible for a transaction to result in one, two, or no change in ownership or control. Other commentators suggested replacing the overlapping shareholder rule of the 2002 proposed regulations with a new rule based on section 355 or 382. Finally, another commentator requested clarification of the application of the overlapping shareholder rule of the 2002 proposed regulations under the 1989 proposed regulations.

These regulations retain the overlapping shareholder rule of the 2002 proposed regulations. The group concepts in section 355 or 382 do not fit well with the overall purpose of section 280G. Finally, these regulations are effective with respect to

changes in ownership or control that occur after January 1, 2004, and to payments that are contingent on such changes. These regulations do not provide any transitional rules for the application of the overlapping shareholder rules for prior periods both because these regulations are not effective for prior periods and because the positions set forth in 2002 proposed regulations are merely clarifications of the positions taken by the IRS under section 280G (illustrated by the 1989 proposed regulations).

International Issues

Commentators recommended that the final regulations provide that a disqualified individual who, during the disqualified individual determination period, was a nonresident alien and was not subject to income tax in the United States on wages earned from the affiliated group, not be subject to the excise tax. Treasury and the IRS do not believe that they have the authority to preclude application of the excise tax to a nonresident alien under these circumstances. Accordingly, the final regulations do not include any special rules for excess parachute payments received by nonresident aliens.

Commentators also requested clarification that, even though parachute payments made by a foreign subsidiary of a U.S. corporation may not be deductible, such payments reduce the foreign subsidiary's earnings and profits. Because this issue has implications beyond section 280G and foreign subsidiaries, it is not addressed in these regulations.

Effective Date and Reliance

These regulations apply to any payments that are contingent on a change in

ownership or control if the change of ownership or control occurs on or after January 1, 2004.

Under the 2002 proposed regulations, taxpayers are permitted to rely on the 2002 proposed regulations until the effective date of the final regulations. Taxpayers are permitted to rely on the 1989 proposed regulations with respect to payments contingent on a change in ownership or control if that change occurs before January 1, 2004. A clarification in the 2002 proposed regulations does not support reliance on the 1989 proposed regulations for a position contrary to the provisions of the 1989 proposed regulations.

Taxpayers are permitted to rely on the 2002 proposed regulations, including for purposes of amended returns with respect to the following: (1) that a shareholder who owns stock with a fair market value of $1 million is not a disqualified individual and (2) that the base amount includes the amount of compensation included in gross income under section 83(b).

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. Section 1.280G-1 of these proposed regulations provides for the collection of information. 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 on the fact that, as indicated in the Paperwork Reduction Act section earlier in the preamble, only 800 small entities are expected to be

affected by the regulations annually, and it is unlikely that any small entity would be affected by these regulations more than once or twice in its existence. 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, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Erinn Madden, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). 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 is amended as follows:

PART I -- INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986.

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

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

Section 1.280G-1 also issued under 26 U.S.C. 280G (b) and (e). * * *

Par. 2. Section §1.280G-1 is added to read as follows:

§1.280G-1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under section 280G of the Internal Revenue Code of 1986, as added by section 67 of the Tax Reform Act of 1984 (Public Law No. 98-369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Public Law No. 99-514; 100 Stat. 2807), section 1018(d)(6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Public Law No. 100-647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Public Law No. 104-188; 110 Stat. 1755). The following is a table of contents of subjects in this section:

Overview

Q-1: What is the effect of Internal Revenue Code section 280G?

A-1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

(b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q-2: What is a parachute payment for purposes of section 280G?

A-2: (a) The term parachute payment means any payment (other than an exempt payment described in Q/A-5) that --

(1) Is in the nature of compensation;

(2) Is made or is to be made to (or for the benefit of) a disqualified individual;

(3) Is contingent on a change --

(i) In the ownership of a corporation;

(ii) In the effective control of a corporation; or

(iii) In the ownership of a substantial portion of the assets of a corporation; and

(4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A-2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

(b) Hereinafter, a change referred to in paragraph (a)(3) of this A-2 is generally referred to as a change in ownership or control. For a discussion of the application of

paragraph (a)(1), see Q/A-11 through Q/A-14; paragraph (a)(2), Q/A-15 through Q/A-21; paragraph (a)(3), Q/A-22 through Q/A-29; and paragraph (a)(4), Q/A-30 through Q/A-36.

(c) The term parachute payment also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a securities violation parachute payment. See Q/A-37 for the definition and treatment of securities violation parachute payments.

Q-3: What is an excess parachute payment for purposes of section 280G?

A-3: The term excess parachute payment means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, see Q/A-37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, see Q/A-38 through Q/A-44.

Q-4: What is the effective date of section 280G and this section?

A-4: In general, section 280G applies to payments under agreements entered

into or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment that is contingent on a change in ownership or control and the change in ownership or control occurs on or after January 1, 2004. For a discussion of the application of the effective date, see Q/A-47 and Q/A-48.

Exempt Payments

Q-5: Are some types of payments exempt from the definition of the term parachute payment?

A-5: (a) Yes, the following five types of payments are exempt from the definition of parachute payment --

(1) Payments with respect to a small business corporation (described in Q/A-6 of this section);

(2) Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A-6 of this section);

(3) Payments to or from a qualified plan (described in Q/A-8 of this section);

(4) Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the Internal Revenue Code: section 501(c) (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)),

section 501(d), or section 529, collectively referred to as tax-exempt organizations (described in Q/A-6 of this section); and

(5) Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A-9 of this section).

(b) Deductions for payments exempt from the definition of parachute payment are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section.

Q-6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A-5 of this section are exempt from the definition of parachute payment?

A-6: (a) The term parachute payment does not include --

(1) Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a corporation under section 1361 in effect on the date of the change in ownership or control;

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A-6) if --

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii) The shareholder approval requirements described in Q/A-7 of this section are met with respect to such payment; or

(3) Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A-5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b) For purposes of paragraph (a)(1) of this A-6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)(2)(i) of this A-6 are not met with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets. If a corporation is a member of an affiliated group (which group is treated as one corporation under A-46 of this section), the requirements of paragraph (a)(2)(i) of this A-6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A-6, the term stock does not include stock described in section 1504(a)(4) if the payment does not adversely affect

the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A-6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A-6, the term established securities market means an established securities market as defined in §1.897-1(m).

(g) The following examples illustrate the application of this exemption:

Example 1. A small business corporation (within the meaning of paragraph (a)(1) of this A-6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2. Assume the same facts as in Example 1, except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A-6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A-7 of this section are met, the payments are not parachute payments.

Example 3. Stock of Corporation S is owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A-2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of parachute payments under this A-6.

Example 4. A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A-5(a)(4), would constitute a parachute payment. However, one or more aspects of the

transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control, as required by this A-6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of parachute payment under this A-6.

Example 5. B is a corporation described in section 501(c)(15). B does not meet the definition of a tax-exempt organization because section 501(c)(15) does not expressly prohibit inurement of B's net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a parachute payment, such payment is not exempt from the definition of the term parachute payment for purposes of this A-6.

Q-7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section met?

A-7: (a) General rule. The shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section are met with respect to any payment if --

(1) Such payment is approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A-7) immediately before the change in ownership or control; and

(2) Before the vote, there was adequate disclosure to all persons entitled to vote (as described in this A-7) of all material facts concerning all material payments which (but for Q/A-6 of this section) would be parachute payments with respect to a disqualified individual.

(b) Voting requirements -- (1) General rule. The vote described in paragraph (a)(1) of this A-7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. Except as otherwise provided in this A-7, the normal

voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A-7. For purposes of this A-7, the vote can be on less than the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A-6 of this section.

(2) Special rule. A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within the six-month period immediately prior to and ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A-7 are met.

(3) Entity shareholder. (i) Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. See paragraph (b)(4) of this A-7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are

not met.

(ii) However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder entitled to vote. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this (b)(3)(ii), stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4) Disqualified individuals and attribution of stock ownership. In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A-7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not

considered in determining whether the more than 75 percent vote has been obtained under this A-7 if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. In addition, if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements described in this A-7 are not met, such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder, or in the case of a trust another person eligible to vote on behalf of the trust, to vote the otherwise eligible shares. However, if all persons who hold voting power in the corporation undergoing the change in ownership or control are disqualified individuals or related persons described in this paragraph (b)(4), then such stock is counted as outstanding stock and votes by such persons are considered in determining whether the more than 75 percent vote has been obtained.

(c) Adequate disclosure. To be adequate disclosure for purposes of paragraph (a)(2) of this A-7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made. Disclosure of such information must be made to every shareholder of the corporation entitled to vote under this A-7. For each

disqualified individual, material facts that must be disclosed include, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are not met, and a brief description of each payment (*e.g.*, accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d) Corporation without shareholders. If a corporation does not have shareholders, the exemption described in Q/A-6(a)(2) of this section and the shareholder approval requirements described in this A-7 do not apply. Solely for purposes of this paragraph (d), a shareholder does not include a member in an association, joint stock company, or insurance company.

(e) Examples. The following examples illustrate the application of this A-7:

Example 1. Corporation S has two shareholders -- Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to certain officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock entitled to vote of Corporation P and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 2. (i) Stock of Corporation X, none of which is traded on an established market, is acquired by Corporation Y. In the voting ballot concerning the

sale, the Corporation X shareholders are asked to vote either "yes" on the sale and "yes" to paying parachute payments to A, a disqualified individual with respect to Corporation A, or "no" on the sale and "no" to paying parachute payments to A.

(ii) Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A-7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of parachute payment pursuant to Q/A-6 of this section.

(iii) Assume the same facts as in paragraph (i) of this Example 2, except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A-7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments can not be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A-7 are met, the payments are exempt from the definition of parachute payment pursuant to Q/A-6 of this section.

Example 3. Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. The general partner is not a disqualified individual. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A-7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 4. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A-7 are not met. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the shareholder approval requirements of paragraph (a)(1) of this A-7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not entitled to vote.

Example 5. Assume the same facts as in Example 4, except that after adequate disclosure of all material facts (within the meaning of paragraph (a)(2) of this A-7) to all shareholders entitled to vote, 60 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent of the shareholders holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6. Assume the same facts as in Example 4 except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A-7) regarding the payments to X and Y is made to two of Corporation A's shareholders, who collectively own 80 percent of Corporation A's stock entitled to vote and approve the payment. Both shareholders approve the payments. Assume further that no adequate disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A-7. Notwithstanding that 80 percent of the shareholders entitled to vote approve the payments, because disclosure regarding the payments to X and Y is not made to all of Corporation A's shareholders who were entitled to vote, the disclosure requirements of paragraph (a)(2) of this A-7 are not met, and the payments are not exempt from the definition of parachute payment pursuant to Q/A-6.

Example 7. Corporation C has three shareholders – Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P's base amount. To determine the persons who are entitled to vote referred to in paragraph (a)(1) of this A-7, one-third of the stock held by Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual who would receive a parachute payment if the requirements of this A-7 are not met), to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8. X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). Each individual has a base amount of $100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of $400,000 is payable to X; $600,000 is payable to Y; and $1,000,000 is payable to Z. Corporation E provides each Corporation E shareholder entitled to vote (as determined under this A-7) with a ballot listing and

describing the payments of $400,000 to X; $600,000 to Y; and $1,000,000 to Z and the triggering event that generated the payments. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a "yes" and "no" box) of each total payment to be made to each individual and states that if the payment is not approved the payment will not be made. Adequate disclosure, within the meaning of this A-7 is made to each shareholder entitled to vote under this A-7. More than 75 percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A-7 approve each payment to each individual. The shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 9. Assume the same facts as in Example 8 except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that $2,000,000 in payments will be made to X, Y, and Z and requests approval of the $2,000,000 payments. Assuming the triggering event and amount of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A-7, the shareholder approval requirements of paragraph (a)(1) of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 10. B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B's base amount is $205,000. Under B's employment agreement with Corporation X, in the event of a change in ownership or control, B's stock options will vest and B will receive severance and bonus payments. Contingent on the change in ownership or control, B's stock options with a fair market value of $500,000 immediately vest, $200,000 of which is contingent on the change, and B will receive a $200,000 bonus payment and a $400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote as described in this A-7. The ballot contains adequate disclosure of all material facts and lists the following payments to be made to B: the contingent payment of $200,000 attributable to options, a $200,000 bonus payment, and a $400,000 severance payment. The ballot requests shareholder approval of the $200,000 bonus payment to B and states that whether or not the $200,000 bonus payment is approved, B will receive $200,000 attributable to options and a $400,000 severance payment. More than 75 percent of the shareholders entitled to vote as described by this A-7 approve the $200,000 bonus payment to B. The shareholder approval requirements of this A-7 are met, and the $200,000 payment is exempt from the definition of parachute payment pursuant to A-6 of this section.

Q-8: Which payments under a qualified plan are exempt from the definition of parachute payment?

A-8: The term parachute payment does not include any payment to or from –

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A simplified employee pension (as defined in section 408(k)); or

(d) A simple retirement account (as defined in section 408(p)).

Q-9: Which payments of reasonable compensation are exempt from the definition of parachute payment?

A-9: Except in the case of securities violation parachute payments, the term parachute payment does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A-37 of this section for the definition and treatment of securities violation parachute payments. See Q/A-40 through Q/A-44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q-10: Who may be the payor of parachute payments?

A-10: Parachute payments within the meaning of Q/A-2 of this section may be paid, directly or indirectly, by--

(i) The corporation referred to in paragraph (a)(3) of Q/A-2 of this section;

(ii) A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets; or

(iii) Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q-11: What types of payments are in the nature of compensation?

A-11: (a) General rule. For purposes of this section, all payments – in whatever form – are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, or a transfer of property. However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b) When payment is considered to be made. Except as otherwise provided in A-11 through Q/A-13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable

year in which it is includible in the disqualified individual's gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c) Prepayment rule. Notwithstanding the general rule described in paragraph (b) of this A-11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and regulations thereunder; see Q/A-32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. However, a disqualified individual may not apply this paragraph (c) of this A-11 to a payment to be made in cash if the present value of the payment would be considered not reasonably ascertainable under section 3121(v) and §31.3121(v)(2)-1(e)(4) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the

applicability of this paragraph (c) to certain payments in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(d) Transfers of property. Transfers of property are treated as payments for purposes of this A-11. See Q/A-12 of this section for rules on determining when such payments are considered made and the amount of such payments. See Q/A-13 of this section for special rules on transfers of stock options.

(e) The following example illustrates the principles of this A-11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of $100,000 and is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the $200,000 payment is made to D at the time of the change in ownership or control. The $400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999(c) with respect to the $400,000 payment. Using discount rate determined under Q/A-32, Corporation X and D determine that the present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) x $100,000) and $60,000 (($300,000/$500,000 x $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 - $40,000) and that of the second excess parachute payment is $340,000 ($400,000 - $60,000). The excise tax on the $400,000 payment is $68,000 ($340,000 x 20 percent). Assume the present value (calculated in accordance with paragraph (c) of this A-11) of $68,000 is $50,000. To prepay the excise tax due on the $400,000 payment, Corporation X must satisfy its obligations under section 4999 with respect to the $50,000, in addition to the $32,000 withholding required with respect to the $200,000 payment.

Q-12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A-12: (a) Except as provided in this A-12 and Q/A-13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which

the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in §1.83-3(a)) to the disqualified individual and becomes substantially vested (as defined in §1.83-3(b) and (j)) in such individual. The amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in §1.83-3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A-12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, for purposes of this section, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) See Q/A-13 of this section for rules on applying this A-12 to transfers of stock options.

(d) The following example illustrates the principles of this A-12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of §1.83-3(c))

and are nontransferable (within the meaning of §1.83-3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Because A's rights in the Corporation M stock become substantially vested (within the meaning of §1.83-3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to $25,000 (100 x $250). See Q/A-38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q-13: How are transfers of statutory and nonstatutory stock options treated?

A-13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in §1.83-7(b)). For purposes of this A-13, vested means substantially vested within the meaning of §1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: the difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value. For purposes of this A-13, valuation may be determined by any method

prescribed by the Commissioner in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(b) Any money or other property transferred to the disqualified individual on the exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A-13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A-11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A-13 treated as an excess parachute payment.

Q-14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A-14: Yes, to the extent not otherwise taken into account under Q/A-12 and Q/A-13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q-15: Who is a disqualified individual?

A-15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the disqualified individual

determination period (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation --

(1) A shareholder (but see Q/A-17 of this section);

(2) An officer (see Q/A-18 of this section); or

(3) A highly-compensated individual (see Q/A-19 of this section).

(b) For purposes of this A-15, a director is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period, the director is, with respect to the corporation, a shareholder (see Q/A -17 of this section), an officer (see Q/A-18 of this section), or a highly-compensated individual (see Q/A -19 of this section).

(c) For purposes of this A-15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

Q-16: Is a personal service corporation treated as an individual?

A-16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service

corporation if it were a corporation, is treated as an individual.

(b) The following example illustrates the principles of this A-16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of highly-compensated individuals of Corporation M as determined under A-19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q-17: Are all shareholders of a corporation considered shareholders for purposes of paragraphs (a)(1) and (b) of Q/A-15 of this section?

A-17: (a) No. Only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation's stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer (see Q/A-18) or highly-compensated individual (see Q/A-19) with respect to the corporation.

(b) For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A-17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§ 1.83-3(b) and (j)), the stock underlying the option

is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A-17, mutual and cooperative corporations are treated as having stock.

(c) The following examples illustrates the principles of this A-17:

Example 1. E, an employee of Corporation A, received options under Corporation A's Stock Option Plan. E's stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period. E does not own, and is not considered to own under section 318, any other Corporation A stock. Two years after the options are granted to E, all of Corporation A's stock is acquired by Corporation B. Under Corporation A's Stock Option Plan, E's options are converted to Corporation B options and the vesting schedule remains the same. Under paragraph (b) of this A-17, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered owned by E. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q&A-15 of this section with respect to Corporation A.

Example 2. Assume the same facts as in Example 1, except that Corporation A's Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. Under paragraph (b) of this A-17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/A-15 of this section with respect to Corporation A.

Example 3. Assume the same facts as in Example 1 except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A's Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. Under paragraph (b) of this A-17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual

during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A-15 of this section with respect to Corporation A.

Q-18: Who is an officer?

A-18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction.

(b) An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A-46 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the

number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A-21 of this section) paid during the disqualified individual determination period.

(d) In determining the total number of employees of a corporation for purposes of this A-18, employees are not counted if they normally work less than 17½ hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be an officer.

Q-19: Who is a highly-compensated individual?

A-19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A-21 of this section) earned during the disqualified individual

determination period (as defined in Q/A-20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b) An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c) The total number of employees of a corporation for purposes of this A-19 is determined in accordance with Q/A-18(d) of this section. However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q-20: What is the disqualified individual determination period?

A-20: The disqualified individual determination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q-21: How is compensation defined for purposes of determining who is a

disqualified individual?

A-21: (a) For purposes of determining who is a disqualified individual, the term compensation means the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a nonqualified deferred compensation plan.

(b) For purposes of this A-21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term related entity includes--

(1) All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3) All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4) Any other entities required to be aggregated with the changed corporation or

a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A-18 and Q/A-19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q-22: When is a payment contingent on a change in ownership or control?

A-22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (But see Q/A-23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A-22, vested means the payment is substantially vested within the meaning of §1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by section 83(c).

(b)(1) For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if --

(i) The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii) A change in ownership or control actually occurs; and

(iii) The event is materially related to the change in ownership or control.

(2) For purposes of paragraph (b)(1)(i) of this A-22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; a significant reduction in the disqualified individual's job responsibilities; and a change in ownership or control as defined in the disqualified individual's employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A-27, 28, or 29 of this section. Whether

other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3) For purposes of determining whether an event (as described in paragraph (b)(2) of this A-22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent on a change in ownership or control because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated with and materially related to a change in ownership or control within the meaning of

paragraph (b)(1) of this A-22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. See Q/A-24 of this section regarding the portion of a payment that is so treated. See also Q/A-8 of this section regarding the exemption for certain payments under qualified plans and Q/A-40 of this section regarding the treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A-22:

Example 1. A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A-22. This is true even though B's termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control.

Example 3. A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C's employment is terminated at any time

over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership or control of the corporation occurs. Six months after the change in ownership or control, C's employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership or control, the termination of C's employment is presumed to be materially related to the change in ownership or control under paragraph (b)(3) of this A-22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership or control under paragraph (b) of this A-22.

Example 4. A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender offer for shares of the corporation's stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership or control of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A-37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5. A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership or control of the corporation occurs and within one year after the date of the change of ownership or control, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change in ownership or control, the payment will not be treated as contingent on a change in ownership or control.

Q-23: May a payment be treated as contingent on a change in ownership or

control if the payment is made under an agreement entered into after the change?

A-23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or are to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (See Q/A-9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. To the extent payments under the agreement have the same value as the payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b) The following examples illustrate the principles of this A-23:

Example 1. Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2. Assume the same facts as in Example 1, except that the agreement

between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A-22 of this section. However, see Q/A-9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3. Assume the same facts as in Example 1, except that prior to the change in ownership or control, the individual and corporation enter into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the individual agrees to give up the right to payments under the pre-change agreement that would be parachute payments if made, in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A-23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q-24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A-24: (a)(1) General rule. Yes. If the payment is a transfer of property, the amount of the payment is determined under Q/A-12 or Q/A-13 of this section. For all other payments, the amount of the payment is determined under Q/A-11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A-24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A-24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A-24 applies to a payment that becomes vested as a result of the change in ownership or control if, without regard to the change in ownership or control, the payment was

contingent only on the continued performance of services for the corporation for a specified period of time and if the payment is attributable, at least in part, to services performed before the date the payment becomes vested. Paragraph (b) or (c) does not apply to any payment (or portion thereof) if the payment is treated as contingent on the change in ownership or control pursuant to Q/A-25 of this section. For purposes of this A-24, vested has the same meaning as provided in Q/A-22(a).

(2) Reduction by reasonable compensation. The amount of a payment under paragraph (a)(1) of this A-24 is reduced by any portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services rendered by the disqualified individual on or after the date of the change of control. See Q/A-9 and Q/A-38 through 44 of this section for rules concerning reasonable compensation. The portion of an amount treated as contingent under paragraph (b) or (c) of this A-24 may not be reduced by reasonable compensation.

(b) Vested payments. This paragraph (b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. In such a case, the portion of the payment, if any, that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the

present value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment. For rules on determining present value, see paragraph (e) of this A-24, Q/A-32, and Q/A-33 of this section.

(c)(1) Nonvested payments. This paragraph (c) applies to a payment that becomes vested as a result of the change in ownership or control to the extent that --

(i) Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii) The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(2) The portion of the payment subject to paragraph (c) of this A-24 that is treated as contingent on the change in ownership or control is the amount described in paragraph (b) of this A-24, plus an amount, as determined in paragraph (c)(4) of this A-24, to reflect the lapse of the obligation to continue to perform services. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.

(3) For purposes of this paragraph (c) of this A-24, the acceleration of the

vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment.

(4) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2) of this A-24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(d) Application of this A-24 to certain payments.-- (1) Benefits under a nonqualified deferred compensation plan. In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A-24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A-24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A-24 and the rules in

Q/A-11 of this section.

(2) Employment agreements. The general rule of paragraph (a) of this A-24 (and not the rules in paragraphs (b) or (c)) applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A-24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. See Q/A-42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3) Vesting due to an event other than services. Neither paragraph (b) nor (c) of this A-24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. However, see Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered

before the date of a change in ownership or control.

(e) Present value. For purposes of this A-24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f) Examples. The following examples illustrate the principles of this A-24:

Example 1. (i) Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of $500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii) Because E was vested in $500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of this A-24, is treated as contingent on the change. Thus, the portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment ($500,000) exceeds the present value of the payment absent the acceleration.

(iii) Assume the same facts as in paragraph (i) of this Example 1, except that E's account balance of $500,000 is not vested. Instead, assume that E will vest in E's account balance of $500,000 in 2 years if E continues to perform services for the next 2 years. Assume further that the SERP provides that all unvested SERP benefits vest immediately on a change in ownership or control and are paid to the participants. Because the vesting of the SERP payment, without regard to the change, depends only on the performance of services for a specified period of time and the payment is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the lesser of the amount of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration, plus an amount to reflect the lapse of the obligation to continue to perform services.

(iv) Assume the same facts as in paragraph (i) of this Example 1, except that in addition to the pay out of the vested account balance of $500,000 on the change in ownership or control, an additional $70,000 will be credited to E's account and included in the payment to E. Because the $500,000 was vested without regard to the change in ownership or control, paragraph (b) of this A-24 applies to the $500,000 payment. Because the $70,000 is not vested, without regard to the change, and is not attributable

to the performance of services prior to the change, the entire $70,000 payment is contingent on the change in ownership or control under paragraph (a) of this A-24.

(v) Assume the same facts as in paragraph (i) of this Example 1, except that the benefit under the SERP is calculated using a percentage of final average compensation multiplied by years of service. If, contingent on the change in ownership or control, E is credited with additional years of service, an adjustment to final average compensation, or an increase in the applicable percentage, any increase in the benefit payable under the SERP is not attributable to the performance of services prior to the change, and the entire increase in the benefit is contingent on the change in ownership or control under paragraph (a) of this A-24.

Example 2. As a result of a change in the effective control of a corporation D, a disqualified individual with respect to the corporation, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example 3. (i) On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of $500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment ($500,000) is made on that date to F. Under these facts, the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, as determined under paragraph (c) of this A-24 is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.,* $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.,* $406,838, the present value on January 15, 2009, of a $500,000 payment on January 15, 2011), plus $115,000 (1 percent x 23

months x $500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is $208,162, the sum of $93,162 ($500,000 - $406,838) + $115,000). This result does not change if F actually remains employed until the end of the 5-year period.

(ii) Assume the same facts as in paragraph (i) of this Example 3, except that the retention bonus will vest on the change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment is treated as contingent on the change in ownership or control as determined under paragraph (c) of this A-24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A-27, which is $0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is $93,573 (1 percent x 23 months x $406,838 (the present value of a $500,000 payment).

Example 4. (i) On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 ($500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be $500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a $500,000 payment to be made on January 15, 2011, is

$406,838. Thus, the portion of the payment treated as contingent on the change is $208,162, the sum of $93,162 ($500,000 - $406,838), plus $115,000 (1 percent x 23 months x $500,000), the amount reflecting the lapse of the obligation to continue to perform services.

Example 5. (i) On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with Q/A-13, is $600,000.

(ii) The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 ($600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $600,000 payment to be made on January 15, 2009, is $549,964. Thus, the portion of the payment treated as contingent on the change is $116,036, the sum of $50,036 ($600,000 - $549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is $66,000 (1 percent x 11 months x $600,000).

Example 6. (i) Assume the same facts as in Example 5, except that the options become vested periodically (absent a change in ownership or control), with one-third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 2008, change in ownership or control and the options to purchase the remaining 10,000 shares vest as a result of the change in ownership or control.

(ii) The payment of the options to purchase 10,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment as determined under paragraph (c) of

this A-24 is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change in ownership or control is the amount by which the accelerated payment on January 16, 2008 ($200,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change in ownership or control, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $200,000 payment to be made on January 15, 2009, is $183,328.38. Thus, the portion of the payment treated as contingent on the change is $38,671.62, the sum of $16,671.62 ($200,000 - $183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is $22,000 (1 percent x 11 months x $200,000).

Example 7. Assume the same facts as in Example 5, except that the option agreement provides that the options will vest either on the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 2008. In such case, the full amount of the payment, $600,000, is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A-24 do not apply. See Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8. On January 1, 2005, E, a disqualified individual with respect to Corporation X, enters into an employment agreement with Corporation X under which E will be paid wages of $200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2006, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of $200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (i.e., amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A-24 applies to the payment and not the rules of paragraphs (b) and (c) of this A-24. See Q/A-42(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q-25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A-25: Yes, for purposes of this section, any payment is presumed to be contingent on such a change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to --

(a) An agreement entered into within one year before the date of a change in ownership or control; or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control. In the case of an amendment described in paragraph (b) of this A-25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q-26: How may the presumption described in Q/A-25 of this section be rebutted?

A-26: (a) To rebut the presumption described in Q/A-25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the content of the agreement or amendment and the circumstances surrounding the

execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

(b) In the case of an agreement described in Q/A-25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control --

(1) A nondiscriminatory employee plan or program as defined in paragraph (c) of this A-26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts

entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c) For purposes of this section, the term nondiscriminatory employee plan or program means: a group term life insurance plan that meets the requirements of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under §601.601(d)(2). Payments under certain other plans are exempt from the definition of parachute payment under Q/A-8 of this section.

(d) The following examples illustrate the application of the presumption:

Example 1. A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change in ownership or control and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 2. Assume the same facts as in Example 1, except that the contract is

entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership or control would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or control even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 3. A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership or control of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. If clear and convincing evidence does not rebut the presumption described in A-25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership or control, the payment is presumed contingent on the change under A-25 of this section. This is true even though A's termination of employment is presumed not to be materially related to the change in ownership or control under Q/ A-22 of this section.

Change in Ownership or Control

Q-27: When does a change in the ownership of a corporation occur?

A-27: (a) For purposes of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A-27), acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is

considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A-28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (See Q/A-29 for rules regarding the transfer of assets of a corporation).

(b) For purposes of paragraph (a) of this A-27, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c) For purposes of this A-27 (and Q/A-28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A-27.

(d) The following examples illustrate the principles of this A-27:

Example 1. Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and an additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2. All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3. Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 40 percent of the value of the

stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group in their acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A-29, Example 3, regarding whether there is a change in ownership or control of P.

Example 4. Assume the same facts as in Example 3, except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock and the former shareholders of Corporation O own stock with a fair market value equal to 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A-29, Example 3, regarding whether there is a change in ownership or control of P.

Example 5. A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation O. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6. Assume the same facts as in Example 5, except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q-28: When does a change in the effective control of a corporation occur?

A-28: (a) Notwithstanding that a corporation has not undergone a change in ownership under Q/A-27, for purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either --

(1) Any one person, or more than one person acting as a group (as determined

under paragraph (e) of this A-28), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

(b) The presumption of paragraph (a) of this A-28 may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a) (1) or (2) of this A-28, a change in the effective control of a corporation is presumed not to have occurred.

(c) In no event does a change in effective control under this A-28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A-27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O's stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A-29 of

this section, O does not have a change in effective control under Q/A-28.

(d) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A-27 of this section).

(e) For purposes of this A-28, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f) For purposes of determining stock ownership, see Q/A-27(c).

(g) The following examples illustrate the principles of this A-28:

Example 1. Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M's voting stock. Because A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no

presumption of a change in effective control pursuant to paragraph (a)(1) of this A-28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), a change in the ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A-27 of this section) because A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example 2. A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q-29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A-29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c) of this A-29), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This A-29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A-

29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q/A-46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not surviving entity.

(b) (1) There is no change in ownership or control under this A-29 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to --

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(1)(iii) of this A-29.

(2) For purposes of paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest in before the transaction, but which is a majority-owned subsidiary of the transferor

corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) For purposes of this A-29, persons will not be considered to be acting as a group merely because they happen to purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) For purposes of determining stock ownership, see Q/A-27(c).

(e) The following examples illustrate the principles of this A-29:

Example 1. Corporation M acquires assets having a gross fair market value of $500,000 from Corporation N (an unrelated corporation) on January 1, 2006. The total gross fair market value of Corporation N's assets immediately prior to the acquisition was $3 million. Since the value of the assets acquired by Corporation M is less than one-third of the total gross fair market value of Corporation N's total assets immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example 2. Assume the same facts as in Example 1. Also assume that on November 1, 2006, Corporation M acquires from Corporation N additional assets having a fair market value of $700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of $1.2 million during the 12-month period ending on November 1, 2006. Since $1.2 million is more than one-third of the total gross fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions ($3

million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 2006.

Example 3. (i) All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P (based on ownership of Corporation P prior the change), the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P. However, a change in the ownership (within the meaning of Q/A-27) of Corporation O occurs.

(ii) The result in paragraph (i) would be the same if immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P. See Q/A-27, Example 4, regarding whether there is a change in ownership or control of O.

Example 4. Corporation P sells all of the stock of its wholly-owned subsidiary, S, to Corporation Y. The fair market value of the affiliated group, determined without regard to its liabilities, is $210 million. The fair market value of S, determined without regard to its liabilities, is $80 million. Because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group.

Three-Times-Base-Amount Test for Parachute Payments

Q-30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A-30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual's base amount (as defined in Q/A-34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same

disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of the payment is a parachute payment. See Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A-37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A-30:

Example 1. A is a disqualified individual with respect to Corporation M. A's base amount is $100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling $400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A's base amount of $100,000 (3 x $100,000 = $300,000).

Example 2. Assume the same facts as in Example 1, except that the payments contingent on the change in the ownership or control of Corporation M total $290,000. Because the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q-31: As of what date is the present value of a payment determined?

A-31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

(b)(1) For purposes of determining whether a payment is a parachute payment, if

a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A-32 of this section and based on reasonable actuarial assumptions.

(2) If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A-31 and for applying the 3-times-base-amount test under Q/A-30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A-30 and this A-31, the obligation to provide health care is permitted to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q-32: What discount rate is to be used to determine present value?

A-32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). See Q/A-24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to

use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q-33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A-33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A-30 of this section, or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section, at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(b) If the estimate made under paragraph (a) of this A-33 is later determined to be incorrect, the 3-times-base-amount test described in Q/A-30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be

reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A-31 of this section, using the discount rate described in A-32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times-base-amount test without regard to the payment described in paragraph (a) of this A-33, a disqualified individual is determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A-33 is made (or becomes certain to be made) if no base amount is allocated to such payment.

(c) To the extent provided in published guidance of general applicability under §601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A-13 of this section is permitted be made, with the valuation subsequently re-determined, and the three-times-base-amount test reapplied.

(d) The following examples illustrate the principles of this A-33:

Example 1. A, a disqualified individual with respect to Corporation M, has a base amount of $100,000. Under A's employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of $250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of $150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M occurs and A receives the first payment of $250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be

terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), because M reasonably estimates that there is a 50-percent or greater probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will be made to A as a result of the change in ownership or control. The present value of the additional payment is determined under Q/A-31 and Q/A-32 of this section.

Example 2. Assume the same facts as in Example 1, except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test, because Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation P, has a base amount of $200,000. Under B's employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of $600,000 and a bonus payment of $400,000. In addition, the agreement provides that if B's employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of $500,000. A change in ownership or control of Corporation P occurs, and B receives the $600,000 and $400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the change. For purposes of applying the 3-times-base-amount test, because Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the date of the change, Corporation P assumes that the $500,000 payment will not be made to B. Eleven months after the change in ownership or control, B's employment is terminated, and the $500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the $500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the $500,000 payment. The entire $500,000 payment is treated as an excess parachute payment.

Q-34: What is the base amount?

A-34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity as

defined in Q/A-21 of this section) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. See Q/A-35 of this section for the definition of base period and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d) The base amount includes the amount of compensation included in income under section 83(b) during the base period. See Q/A-35 for the definition of base period.

(e) The following example illustrates the principles of this A-34:

Example. A disqualified individual, D, receives an annual salary of $500,000 per year during the 5-year base period. D defers $100,000 of D's salary each year under the corporation's nonqualified deferred compensation plan. D's base amount is $400,000 ($400,000 x (5/5)).

Q-35: What is the base period?

A-35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A-27, Q/A-28, or Q/A-29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A-21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A-34 of this section and this Q/A-35:

Example 1. A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D's includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year, and $150,000 for the second full year. D's base amount is $120,000, ((3 x $30,000) + $120,000 + $150,000) / 3.

Example 2. Assume the same facts as in Example 1, except that D also received a $60,000 signing bonus when D's employment with the corporation commenced at the beginning of the 4-month period. D's base amount is $140,000, (($60,000 + (3 x $30,000)) + $120,000 + $150,000) / 3. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D's compensation for the 4-month period.

Example 3. E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives $30,000 per year for E's services. In 2006, E

becomes an officer of X. E's includible compensation from Corporation X is $250,000 for 2006 and 2007, and $300,000 for 2008. In 2008, X undergoes a change in ownership or control. E's base amount is $140,000 ((2 x $250,000) + (2 x $30,000)/4).

Q-36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A-21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A-36: (a) In such a case, the individual's base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which --

(1) Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2) Was not contingent on the change in ownership or control; and

(3) Was not a securities violation parachute payment.

(b) The following examples illustrate the principles of this A-36:

Example 1. On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A-21 of this section). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 2006, after A has received compensation of $60,000, a change in the ownership or control of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the $420,000 payment is

contingent on the change is not rebutted. Thus, the payment of $420,000 is treated as contingent on the change in ownership or control of Corporation M. In this case, A's base amount is $120,000 (2 x $60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M ($420,000) is more than 3 times A's base amount of $120,000 (3 x $120,000 = $360,000), the payment is a parachute payment.

Example 2. Assume the same facts as in Example 1, except that A also receives a signing bonus of $50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership or control. When the change in ownership or control occurs on July 1, 2006, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A's base amount is $170,000 ($50,000 + (2 x $60,000)). Because the $50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment ($420,000) is less than 3 times A's base amount of $170,000 (3 x $170,000 = $510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q-37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A-37: (a) No, the term parachute payment also includes any payment (other than a payment exempted under Q/A-6 or Q/A-8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be made --

(1) Pursuant to an agreement that violates any generally enforced Federal or state securities laws or regulations; and

(2) In connection with a potential or actual change in ownership or control.

(b) A violation is not taken into account under paragraph (a)(1) of this A-37 if it is merely technical in character or is not materially prejudicial to shareholders or potential

shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A-37 are referred to in this section as securities violation payments.

(c) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A-22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A-38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(d) The rules in paragraph (b) of this A-37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with

respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(e) The following examples illustrate the principles of this A-37:

Example 1. A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A-37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2. Assume the same facts as in Example 1, except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of parachute payment pursuant to Q/A-9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second

payment does not equal or exceed three times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4. Assume the same facts as in Example 3, except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q-38: How is the amount of an excess parachute payment computed?

A-38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. See Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value and Q/A-34 of this section for the definition of base amount.

(b) The following example illustrates the principles of this A-38:

Example. An individual with a base amount of $100,000 is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) x $100,000) and $60,000 (($300,000/$500,000) x $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 - $40,000) and that of the second is $340,000 ($400,000 - $60,000).

Q-39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A-39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A-24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A-6 through Q/A-9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion

of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) The following examples illustrate the principles of this A-39:

Example 1. Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000 - $100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation.

Example 2. Assume the same facts as in Example 1, except that the full amount of the $600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of $500,000 is reduced to zero by $500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q-40: How is it determined whether payments are reasonable compensation?

A-40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following--

(1) The nature of the services rendered or to be rendered;

(2) The individual's historic compensation for performing such services; and

(3) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b) For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q-41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A-41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A-26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. Q/A-46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A-41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of parachute payment under Q/A-8 of this section.

Q-42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A-42: (a) Yes, if payments are made or to be made to (or on behalf of) a

disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control --

(1) The payments were made or are to be made only for the period the individual actually performs such personal services; and

(2) If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. However, except as provided in paragraph (b) and (c) of this A-42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services contemplated in exchange for the compensation.

(b) Generally, an agreement under which the disqualified individual must refrain from performing services (e.g., a covenant not to compete) is an agreement for the performance of personal services for purposes of this A-42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable

likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A-44 of this section.

(c) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control --

(1) The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;

(2) The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;

(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer (including involuntary termination or constructive discharge); and

(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning

of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A-44 of this section for rules regarding damages for a failure to make severance payments.

(d) The following examples illustrate the principles of this A-42:

Example 1. A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for $100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with A that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A's prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Example 2. Assume the same facts as in Example 1, except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Example 3. Assume the same facts as in Example 1, except that under the new contract A agrees to perform consulting services to Corporation N, when and if Corporation N requires A's services. Assume further that when Corporation N does not require A's services, the contract provides that A must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A-42. Assuming the requirements of paragraph (a) of this A-42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of parachute

payment pursuant to Q/A-9 of this section.

Example 4. Assume the same facts as in Example 1, except that instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A's ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5. Assume the same facts as in Example 1, except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Q-43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A-43: Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q-44: May severance payments be treated as reasonable compensation?

A-44: (a) No, severance payments are not treated as reasonable compensation

for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term severance payment means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual's employment, whenever occurring.

(b) The following example illustrates the principles of this A-44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of $200,000 for the first year of the contract, and for each succeeding year, an annual salary that is $100,000 higher than the previous year. In the event of A's termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X, A's employment is terminated, and A receives $700,000 ($300,000 for the second year of the contract plus $400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the $700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after the date of the change in ownership or control. Thus, the full amount of the $700,000 is a parachute payment.

Miscellaneous Rules

Q-45: How is the term corporation defined?

A-45: For purposes of this section, the term corporation has the meaning prescribed by section 7701(a)(3) and §301.7701-2(b) of this Chapter. For example, a corporation, for purposes of this section, includes a publicly traded partnership treated

as a corporation under section 7704(a); an entity described in §301.7701-3(c)(1)(v)(A) of this Chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q-46: How is an affiliated group treated?

A-46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A-6, Q/A-7 of this section (except as provided therein)), payor of parachute payments (Q/A-10 of this section), disqualified individuals (Q/A-15 through Q/A-21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A-26 of this section (except as provide therein)), change in ownership or control (Q/A-27, 28, and 29 of this section), and reasonable compensation (Q/A-42, 43, and 44 of this section).

Effective Date

Q-47: What is the general effective date of section 280G?

A-47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract

entered into on the day the renewal takes effect.

(b) For purposes of paragraph (a) of this A-47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c) Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a supplement to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)(1) Except as otherwise provided in paragraph (e) of this A-47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented --

(i) To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(ii) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(iii) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2) For purposes of paragraph (a) of this A-47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e) A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following--

(1) The length of time between the adjustment and the change in ownership or control;

(2) The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3) A comparison of the adjustment with historical practices of the corporation;

(4) The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15,

1984, parachute contracts; and

(5) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q-48: What is the effective date of this section?

A-48: This section applies to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

Par 3. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where Identified and described	Current OMB control No.
* * * * *	
1.280G-1	1545-1851
* * * * *	

Robert E. Wenzel
Deputy Commissioner for Services and Enforcement.

Approved: July 14, 2003

Pamela F. Olson
Assistant Secretary of the Treasury.

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also, Part 1, 280G)

Rev. Proc. 2003-68

SECTION 1. PURPOSE

This revenue procedure provides guidance on the valuation of stock options solely for purposes of §§ 280G and 4999 of the Internal Revenue Code. This revenue procedure restates and modifies Revenue Procedure 2002-13, 2002-8 I.R.B. 549, as modified by Revenue Procedure, 2002-45, 2002-27 I.R.B 40.

SECTION 2. BACKGROUND

Section 280G denies a deduction for any excess parachute payment. Section 4999 imposes a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, within the meaning of § 280G(b).

An excess parachute payment is defined in § 280G(b)(1) as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment.

Section 280G(b)(2)(A) defines a parachute payment as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such

payment is contingent on a change in the ownership of a corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation (a change in ownership or control), and (ii) the aggregate present value of the payments in the nature of compensation which are contingent on such change equals or exceeds an amount equal to 3 times the base amount. A parachute payment also includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual if the payment is pursuant to an agreement that violates any generally enforced securities laws or regulations.

A payment in the nature of compensation for purposes of § 280G includes the transfer of an option (including an option to which § 421 applies), without regard to whether the option has a readily ascertainable fair market value within the meaning of § 83. An option is considered transferred when the option becomes substantially vested (within the meaning of §1.83-3(b) and (j) of the Income Tax Regulations). Thus, for purposes of § 280G, stock options must be valued when a payment in the nature of compensation includes the transfer of a stock option, such as the grant or vesting of a stock option, in connection with a change in ownership or control. This revenue procedure provides guidance on the valuation of a stock option for this purpose. However, this revenue procedure does not apply for purposes of valuing a payment in cash (or property), even though the amount of the payment is determined by reference to the cancellation of a stock option.

Pursuant to §1.280G-1, Q/A-13, the value of an option is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: the difference between the option's

exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. For purposes of Q/A-13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability.

The determination of when there has been a change in ownership or control for purposes of section 280G is made under § 1.280G-1, Q/A-27 through Q/A-29.

Section 1.280G-1, Q/A-33, provides that, to the extent provided in published guidance of general applicability, an initial estimate of the value of an option is permitted to be made, with the valuation subsequently re-determined, and the base amount reallocated.

Rev. Proc. 98-34, 1998-1 C.B. 983, provides a methodology for the valuation of certain stock options for purposes of gift, estate, and generation-skipping transfer taxes. The methodology described in Rev. Proc. 98-34 is an option pricing model that takes into account factors similar to those established by the Financial Accounting Standards Board in Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995) (FAS 123). The methodology in Rev. Proc. 98-34 applies only to the valuation of a nonpublicly traded stock option for stock that, on the valuation date, is publicly traded on an established securities market.

Concurrently with the issuance of proposed regulations under section 280G (see § 1.280G-1 of the Proposed Income Tax Regulations at 67 Fed. Reg. 7630), Rev. Proc. 2002-13 was issued concerning the valuation of stock options (including a safe harbor valuation method) for purposes of §§ 280G and 4999. Rev. Proc. 2002-45 modified

various portions of Rev. Proc. 2002-13.

This revenue procedure restates and further modifies Rev. Proc. 2002-13 and Rev. Proc. 2002-45 to address additional issues regarding the valuation of stock options in connection with a change in ownership or control under §§ 280G and 4999.

SECTION 3. STOCK OPTION VALUATION

.01 General rule. A taxpayer may value a stock option, without regard to whether the option is on publicly or nonpublicly traded stock, using any valuation method that (i) is consistent with generally accepted accounting principles (such as FAS 123 or a successor standard) and (ii) takes into account the factors provided in § 1.280G-1, Q&A 13. The safe harbor method provided in section 4 of this revenue procedure and Rev. Proc. 98-34 are considered consistent with generally accepted accounting principles and take into account the factors provided in § 1.280G-1, Q&A 13. For purposes of §§ 280G and 4999 and this revenue procedure, the value of a stock option will not be considered properly determined if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change in ownership or control.

.02 Payment date. For purposes of this revenue procedure, the valuation date is the payment date as determined in accordance with § 280G. Thus, the valuation of a stock option is determined based on the spread, the volatility of the underlying stock, the option term, and any other relevant factors as of that date.

.03 Substitution of an option. If, in addition to vesting, there is, contingent on the change in ownership or control, a substitution of an option on different stock for the option, the valuation is based on the substituted option.

.04 Recalculation. Pursuant to § 1.280G-1, Q/A-33, for purposes of §§ 280G and 4999, the payor is permitted to re-determine the value of an option, during the 18-month period beginning on the date of the change in ownership or control (the re-determination period), in accordance with this revenue procedure. Recalculation is permitted if, during the re-determination period, either of the following occurs: (1) there is a change in the term of the option due to a termination of employment, or (2) there is a change in the volatility of the stock.

Without regard to whether the value of the option will be re-determined, an initial determination of the value of the option must be made in accordance with this revenue procedure. This initial valuation is the amount of the payment, subject to adjustment as otherwise applicable (e.g., pursuant to § 1.280G-1, Q/A-24). This amount is used both to determine whether there are parachute payments and to calculate excess parachute payments and any excise tax liability associated with the transfer of the option.

A recalculation under this revenue procedure must be determined as of the date of payment used in the initial calculation (i.e., the valuation date). Thus, while the term assumption and the volatility assumption are permitted to be re-determined, the spread and the interest rate assumptions continue to be determined as of the valuation date.

For purposes of re-determining the value of the option, an employer is permitted to use a method other than the method used in making the initial determination, provided that both methods are otherwise permitted under this revenue procedure.

If the value of an option is recalculated under this revenue procedure, parachute payments and excess parachute payments must be recalculated using the re-determined valuation. However, the base amount does not have to be re-apportioned;

instead, the base amount allocated to the parachute payment is permitted to remain the same, with any adjustment to the excise tax made with respect to the option. This adjustment may be claimed only by filing an amended return for the taxable year that includes the payment date.

SECTION 4. VALUATION SAFE HARBOR

.01 In general. The safe harbor valuation method provided by this revenue procedure is based on the Black-Scholes model and takes into account, as of the valuation date, the following factors: (1) the volatility of the underlying stock, (2) the exercise price of the option, (3) the value of the stock at the time of the valuation (the "spot price"), and (4) the term of the option on the valuation date. The safe harbor value of the option equals (i) the number of shares covered by the options multiplied by (ii) the spot price of the stock, and then multiplied by (iii) a valuation factor determined using the factors described above and reflected in the Table at the end of this revenue procedure. Other relevant factors, including risk-free rate of interest and assumptions related to dividend yields, are included in the Table. To determine the valuation factor, the taxpayer must determine the volatility, spread, and option term factors, as described below. To rely on this revenue procedure, assumptions made for purposes of this revenue procedure and the determination of each factor must be reasonable and consistent with assumptions made with respect to other options that may be valued in connection with the change in ownership or control.

.02 Volatility. The taxpayer must determine whether the volatility of the underlying stock is low, medium, or high. If the valuation is based on a substituted option pursuant to section 3.03, volatility is determined based on the stock under the

substituted option. For this purpose, a low volatility stock has an annual standard deviation of 30 percent or less. A medium volatility stock has an annual standard deviation greater than 30 percent but less than 70 percent. A high volatility stock has an annual standard deviation of 70 percent or greater. If the stock is publicly traded on an established securities market (or otherwise), the expected volatility of the underlying stock used for purposes of volatility under this revenue procedure must be the volatility for the most recent year disclosed in the most recent financial statements of the corporation. If the stock is not publicly traded on an established securities market or otherwise, but the stock is required to be registered under the Securities Exchange Act of 1934, the volatility for such stock is assumed to be the same as the volatility for a comparable corporation that is publicly traded. For this purpose, whether a corporation is considered comparable is determined by comparing relevant characteristics such as industry, corporate size, earnings, market capitalization, and debt-equity structure. If the stock is not publicly traded and the corporation is not required to register under the Securities Exchange Act of 1934, the taxpayer must assume medium volatility. If the stock is not required to be registered under the Securities Exchange Act of 1934, but the corporation voluntarily registers its stock and its stock is publicly traded, the corporation must use the volatility of the underlying stock.

.03 Spread between exercise price and spot price. The factor based on the spread between the exercise price and the spot price is calculated by dividing the spot price by the exercise price and subtracting 1. If the stock is not publicly traded, the determination of the spot price for this purpose must be reasonable and consistent with the price, if any, otherwise determined for the stock in connection with the transaction

giving rise to the change in ownership or control under § 280G(b)(2)(A). For purposes of determining the factor based on the spread between the exercise price and the spot price under the Table, the resulting percentage may be rounded down to the next lowest interval. If this factor exceeds 220%, this safe harbor valuation method cannot be used to value the stock option.

.04 Term of the option. The term of the option is the number of full months between the valuation date and the latest date on which the option will expire. For purposes of determining the term factor under the table, the number of full months may be rounded down to the next lowest 12-month interval. If the term of the option exceeds 10 years (120 months), then this safe harbor valuation method cannot be used to value the stock option. If the remaining term of the option is less than 12 months, the taxpayer may round down to the 3-month interval. For purposes of this paragraph, the taxpayer is permitted to use the expected term of the option calculated in accordance with Rev. Proc. 98-34.

SECTION 5. EXAMPLE

E is an employee of Corporation A, a publicly traded corporation. On September 1, 2004, in connection with E's performance of services, A grants E options to purchase 100,000 shares of A stock at $10 per share. The options are exercisable for 10 years. The options will vest on September 1, 2007, if E continues to be employed by A through that date, or on a change in ownership or control, if earlier. Under the terms of the option, if E's employment is terminated after the option is vested, the option must be exercised on or before the date that is 3 months after the termination of employment.

On September 15, 2005, Corporation B acquires all of the stock of A, and A is

merged into B. Contingent on the change in ownership, E's options become fully vested and are converted into B options with the same aggregate spread and the same ratio between the exercise price and the value of the stock (determined immediately before the conversion). At the time of the vesting, A stock has a fair market value of $20, and B stock has a fair market value of $50. Thus, in connection with the change in ownership, E receives fully vested options for 40,000 shares of B stock with an exercise price of $25. The date of the vesting and substitution is the payment date and, therefore, the valuation date.

Using a valuation method that complies with this revenue procedure, B determines that, as of the valuation date, it is reasonable to assume that the volatility of B stock is .25, that the remaining expected term of the option is 36 months, and that the risk-free interest rate is 5%. B determines that the value of the option is $1,096,000 (or $27.40 per share).

Without regard to the change in ownership, this payment was contingent only on continued performance of services for Corporation A for a specified period of time and the payment is attributable, in part, to the performance of services before the date the payment was made. Therefore, the portion of the payment that is contingent on the change in ownership is determined under § 1.280G-1, Q/A-24(c). The acceleration of the vesting of a stock option is considered to significantly increase the value of the payment. Therefore, the future value of the payment is assumed to be equal to the payment. Under § 1.280G-1, Q/A-31 and 32, the present value of the option is determined to be $975,000. The vesting of the option has been accelerated by 23 full months. Therefore, the portion of the payment that is contingent on the change in

ownership is $373,080, the sum of (1) $121,000 (the amount by which $1,096,000, exceeds $975,000), and (2) $252,080 (23 months times 1% times $1,096,000).

The value of the payment related to the options, $373,080, is taken into account for purposes of determining whether A has received parachute payments and, if so, the portion of the parachute payments that are excess parachute payments. For purposes of this example, assume E is receiving parachute payments and that $50,000 in base amount is allocated to this payment. In that case, $323,080 of the payment is an excess parachute payment, and the excise tax under section 4999 is $64,616. B must satisfy its obligations under section 4999(c) with respect to this amount, and E is responsible for the excise tax related to this payment for E's 2005 taxable year. B cannot claim the amount of the excess parachute payment as a deduction.

On July 1, 2006, E's employment is terminated, shortening the term of the option. As a result, the actual term of the option, measured from the date of the change in ownership, is 12 months (the 9 full months that E was employed following the change in ownership plus the 3 months following a termination of employment during which E can exercise the option). B decides to recalculate the value of the options as of the valuation date in accordance with section 3.04 of this revenue procedure, using the value of B stock at the change of ownership, $50, and the exercise price of $25 a share. In addition, B uses the same 5% risk-free assumption rate used in the initial valuation. Finally, B determines that .25 continues to be a reasonable assumption for volatility. The value of the option, as recalculated, is $1,030,000 (or $25.75 a share).

This value is then used to re-determine the portion of the payment that is contingent on the change in ownership under § 1.280G-1, Q/A-24(c). This amount is

$350,800, the sum of (1) $113,900 (the amount by which the value of the payment, $1,030,000, exceeds the present value of the payment, determined to be $916,100), and (2) $236,900 (23 times 1% times $1,030,000). Using the base amount initially allocated to this payment, $50,000, the portion of the payment that is an excess parachute payment is $300,800, and the excise tax is $60,160. E is permitted to file an amended return for 2005 using the revised calculations as a basis for claiming a refund of $4,456.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-13, 2002-8 I.R.B. 549, and Rev. Proc. 2002-45, 2002-27 I.R.B. 40, are revoked as of January 1, 2004.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective January 1, 2004. Taxpayers are permitted to apply this revenue procedure with respect a change in ownership or control occurring prior to such date.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Erinn Madden of the Office of Chief Counsel of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue procedure, contact Ms. Madden at (202) 622-6030 (not a toll free call).

TABLE

	Term (months)	3	12	24	36	48	60	72	84	96	108	120
Volatility	Spread Factor*											
Low	200%	66.8%	67.3%	67.9%	68.4%	69.0%	69.5%	69.9%	70.3%	70.7%	71.0%	71.2%
	180%	64.5%	65.0%	65.7%	66.4%	67.1%	67.7%	68.3%	68.8%	69.3%	69.6%	69.9%
	160%	61.8%	62.4%	63.3%	64.1%	65.0%	65.8%	66.5%	67.1%	67.7%	68.1%	68.5%
	140%	58.6%	59.4%	60.4%	61.5%	62.5%	63.5%	64.4%	65.1%	65.8%	66.4%	66.9%
	120%	54.9%	55.8%	57.1%	58.4%	59.7%	60.9%	62.0%	62.9%	63.7%	64.5%	65.1%
	100%	50.4%	51.5%	53.2%	54.8%	56.4%	57.9%	59.1%	60.3%	61.3%	62.2%	63.0%
	80%	44.9%	46.3%	48.5%	50.6%	52.6%	54.3%	55.9%	57.3%	58.5%	59.6%	60.5%
	60%	38.0%	40.0%	42.9%	45.6%	48.0%	50.1%	52.0%	53.7%	55.2%	56.5%	57.6%
	40%	29.3%	32.3%	36.3%	39.7%	42.6%	45.2%	47.4%	49.4%	51.2%	52.7%	54.1%
	20%	18.1%	23.3%	28.5%	32.7%	36.2%	39.3%	41.9%	44.3%	46.4%	48.2%	49.9%
	0%	6.4%	13.6%	19.9%	24.7%	28.8%	32.3%	35.4%	38.1%	40.5%	42.7%	44.7%
	-20%	0.6%	5.4%	11.2%	16.1%	20.4%	24.2%	27.6%	30.6%	33.4%	35.9%	38.1%
	-40%	0%	0.9%	4.1%	7.9%	11.6%	15.2%	18.5%	21.7%	24.6%	27.3%	29.9%
	-60%	0%	0.0%	0.6%	2.0%	4.0%	6.4%	9.0%	11.6%	14.3%	16.8%	19.3%
Medium	200%	66.8%	67.4%	68.6%	69.9%	71.1%	72.2%	73.1%	73.9%	74.5%	75.0%	75.4%
	180%	64.5%	65.2%	66.7%	68.2%	69.6%	70.9%	71.9%	72.8%	73.5%	74.1%	74.6%
	160%	61.8%	62.7%	64.5%	66.3%	68.0%	69.4%	70.6%	71.6%	72.5%	73.2%	73.7%
	140%	58.6%	59.8%	62.0%	64.2%	66.1%	67.7%	69.1%	70.3%	71.2%	72.0%	72.7%
	120%	54.9%	56.4%	59.2%	61.7%	63.9%	65.8%	67.4%	68.8%	69.9%	70.8%	71.6%
	100%	50.4%	52.5%	55.9%	58.9%	61.5%	63.7%	65.5%	67.0%	68.3%	69.4%	70.3%
	80%	44.9%	47.9%	52.2%	55.7%	58.7%	61.2%	63.2%	65.0%	66.5%	67.7%	68.8%
	60%	38.2%	42.6%	47.8%	52.0%	55.4%	58.3%	60.6%	62.7%	64.3%	65.8%	67.0%
	40%	30.0%	36.3%	42.7%	47.6%	51.6%	54.8%	57.6%	59.9%	61.8%	63.5%	64.9%
	20%	20.3%	29.1%	36.8%	42.5%	47.0%	50.8%	53.9%	56.5%	58.8%	60.7%	62.3%
	0%	10.4%	21.2%	30.0%	36.4%	41.6%	45.8%	49.4%	52.4%	55.0%	57.2%	59.1%
	-20%	3.0%	13.0%	22.2%	29.2%	34.9%	39.7%	43.7%	47.2%	50.2%	52.8%	55.0%
	-40%	0.3%	5.7%	13.8%	20.8%	26.8%	32.0%	36.4%	40.4%	43.8%	46.8%	49.5%
	-60%	0%	1.2%	5.9%	11.4%	16.9%	22.1%	26.7%	31.0%	34.8%	38.3%	41.4%
High	200%	66.8%	68.1%	70.7%	73.1%	75.0%	76.6%	77.8%	78.8%	79.5%	80.0%	80.4%
	180%	64.5%	66.1%	69.1%	71.7%	73.9%	75.6%	77.0%	78.1%	78.9%	79.5%	79.9%
	160%	61.8%	63.8%	67.3%	70.3%	72.7%	74.6%	76.1%	77.3%	78.2%	78.9%	79.4%
	140%	58.6%	61.3%	65.3%	68.6%	71.3%	73.4%	75.1%	76.4%	77.4%	78.2%	78.8%
	120%	54.9%	58.3%	63.0%	66.8%	69.7%	72.1%	73.9%	75.4%	76.6%	77.4%	78.1%
	100%	50.6%	55.0%	60.4%	64.6%	67.9%	70.6%	72.6%	74.3%	75.6%	76.6%	77.3%
	80%	45.3%	51.1%	57.4%	62.2%	65.9%	68.8%	71.1%	73.0%	74.4%	75.6%	76.5%
	60%	39.1%	46.6%	54.0%	59.4%	63.5%	66.8%	69.4%	71.4%	73.1%	74.4%	75.4%
	40%	31.7%	41.4%	50.0%	56.1%	60.7%	64.4%	67.3%	69.6%	71.5%	73.0%	74.2%
	20%	23.2%	35.4%	45.3%	52.1%	57.4%	61.5%	64.8%	67.4%	69.6%	71.3%	72.7%
	0%	14.3%	28.5%	39.6%	47.4%	53.3%	57.9%	61.6%	64.7%	67.1%	69.1%	70.8%
	-20%	6.4%	20.8%	32.9%	41.5%	48.1%	53.4%	57.6%	61.1%	64.0%	66.4%	68.3%
	-40%	1.5%	12.7%	24.8%	34.0%	41.4%	47.3%	52.2%	56.3%	59.7%	62.5%	64.8%
	-60%	0.1%	5.2%	15.2%	24.3%	32.1%	38.8%	44.4%	49.1%	53.2%	56.6%	59.5%

*Spot (market) Price/Exercise Price - 1 or (S/X-1)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 1, 2003
JS-629

Treasury Issues Final Regulations Regarding Prepayments Financed With Tax-Exempt Bonds

Today the Treasury Department and the Internal Revenue Service issued final regulations that specify the types of prepayments for property or services that are eligible for tax-exempt financing.

Regulations promulgated in 1993 limit the availability of tax-exempt financing for prepayments. On April 17, 2002, proposed amendments to the existing regulations were published in the Federal Register. Under the new final regulations, the categories of prepayments eligible for tax-exempt financing include not only certain prepayments for natural gas, as provided in the 2002 proposed regulations, but also certain prepayments for electricity. The natural gas and electricity prepayment provisions in the new final regulations generally permit interest exclusion if at least 90 percent of the natural gas or electricity is furnished to retail customers in the service area of the municipal utility. These new provisions will assist municipal utilities in securing long-term supplies of natural gas and electricity at reasonable prices, and will support initiatives to restructure energy markets.

Related Documents:

- The Text of the Final Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9085]

RIN 1545-AY12

Arbitrage and Private Activity Restrictions Applicable to Tax-exempt Bonds Issued by State and Local Governments; Investment-type Property (prepayment); Private Loan (prepayment).

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. These regulations affect issuers of tax-exempt bonds and provide guidance on the definitions of investment-type property and private loan to help issuers comply with the arbitrage and private activity restrictions.

DATES: Effective Date: These regulations are effective October 3, 2003.

Applicability Date: For dates of applicability, see §§1.141-15(b)(3) and 1.148-11(j) of these regulations.

FOR FURTHER INFORMATION CONTACT: Johanna Som de Cerff (202) 622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) under sections 141 and 148 of the Internal Revenue Code by providing rules for determining whether a prepayment for property or services results in a private loan or investment-type property (the final regulations). On April 17, 2002, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-113526-98; REG-105369-00)(67 FR 18835)(the proposed regulations). The proposed regulations modify §§1.141-5(c)(2) and 1.148-1(e) of the Income Tax Regulations to establish which prepayments for property or services give rise to a private loan under section 141(c) or investment-type property under section 148(b)(2)(D). On September 25, 2002, the IRS held a public hearing on the proposed regulations. Written comments responding to the proposed regulations were also received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

I. Investment-type Property

A. Existing regulations

The existing regulations, at §1.148-1(e)(2), contain rules for determining when a prepayment for property or services results in investment-type property. Under that provision, a prepayment generally gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. However, a prepayment does not give rise to investment-type property under the existing regulations if (1) it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment (the business purpose exception); or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the customary exception).

B. Business purpose exception

The proposed regulations narrow the scope of the business purpose exception. Under the proposed regulations, a prepayment meets the business purpose exception only if the primary purpose for the prepayment is to accomplish one or

more substantial business purposes that (1) are unrelated to any investment return based on the time value of money and (2) cannot be accomplished without the prepayment.

Commentators suggested that the business purpose exception in the proposed regulations would have limited usefulness and that the language in the existing regulations is superior. However, as discussed in the preamble to the proposed regulations, the business purpose exception in the existing regulations was intended to be a narrow exception and has raised difficult interpretive questions. For example, in many instances it may be unclear whether the alternatives available to the issuer are "commercially reasonable." The IRS and Treasury Department have considered all of the comments relating to the business purpose exception and have concluded that a standard that considers whether one or more business purposes and/or commercially reasonable alternatives exist is not an administrable test for determining whether prepayments give rise to investment-type property. Therefore, based on tax administration considerations and the broad scope of the investment-type property concept, the final regulations delete the business purpose exception. However, the final regulations provide that the Commissioner may, by published

guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

C. Customary exception

The proposed regulations retain the customary exception in its present form. Commentators expressed concern that the customary exception may be difficult to apply in some cases. They suggested that the regulations identify examples of prepayments that satisfy the exception. The final regulations retain the customary exception and indicate that it generally applies based on all the facts and circumstances. In addition, the final regulations contain a safe harbor under which a prepayment is deemed to satisfy the customary exception if: (1) the prepayment is made for maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment), or updates or maintenance or support services with respect to computer software; and (2) the same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

D. Certain prepayments to acquire a supply of natural gas or electricity

1. Prepayments for Natural Gas

The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person, as defined in §1.141-1(b) (for example, if a joint action agency acquires a natural gas supply for one or more municipal gas or electric utilities). The exception applies only if at least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail customers in the service area of a municipal gas utility, or used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under state or Federal law (the use requirement). For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law.

Some commentators recommended that the 95 percent threshold be reduced to 85 percent. These commentators stated that various factors make it difficult for municipal gas

utilities to determine in advance the precise quantity of gas supplies they will need to serve their customers during a given period. These factors include a limited capability to store gas and variations in demand due to circumstances beyond the utilities' control, such as economic conditions and the weather. In recognition of these unique factors, the final regulations reduce the 95 percent threshold to 90 percent.

Some commentators recommended that the use requirement apply based on the issuer's reasonable expectations as of the issue date. To ensure that the prepaid gas is consumed by retail customers in the service area of the municipal utility, the final regulations retain the requirement that the prepaid gas supply actually be used for a qualifying purpose.

Some commentators suggested that the use of natural gas to fuel the transportation of the prepaid gas supply on a pipeline should be a qualifying use under the natural gas exception. The final regulations adopt this comment. Under the final regulations, the use of gas to fuel the pipeline transportation of the prepaid gas supply is a qualifying use and is not pro-rated based on the amount of qualified and nonqualified use of the remaining prepaid gas.

Commentators indicated that most municipal gas and electric utilities do not have an obligation to serve that

arises under state or Federal law. These commentators suggested replacing the "obligation to serve" requirement for municipal electric utilities with a service area rule that is similar to the rule for municipal gas utilities. The final regulations adopt this comment. Commentators also recommended that the definition of service area be expanded to include any area recognized as the service area of the municipal utility under state or Federal law. The final regulations adopt this comment.

Commentators requested clarification that sales to governmental persons are qualifying sales under the use test. Commentators also requested clarification that a retail customer of a municipal utility is a qualifying end-user even if the prepayment was made by or for another municipal utility. The final regulations do not provide that all sales to governmental persons, or to retail customers of a municipal utility, are qualifying sales. Rather, the final regulations clarify that, in the case of a natural gas prepayment by or for one or more municipal utilities (each, the issuing municipal utility), the use of prepaid gas is a qualifying use if the gas is: (1) furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility (other than

sales of gas to produce electricity for sale); (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; (3) used by the issuing municipal utility to produce electricity that will be sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser; (4) sold to a municipal utility if the requirements of (1), (2) or (3) of this paragraph are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or (5) used to fuel the transportation of the prepaid gas supply on a pipeline. Thus, for example, the sale of gas or electricity by the issuing municipal utility directly to customers of another municipal utility is not a qualifying use.

Some commentators recommended that the final regulations define "retail customer" as a customer that is not purchasing for resale. The final regulations provide that a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale. The final regulations also clarify that the consumption of natural gas by a nongovernmental person to produce electricity for sale is

not a qualifying use of natural gas under the 90 percent use test.

Some commentators requested clarification of which "contiguous" areas may be treated as part of a municipal utility's service area. One commentator suggested that contiguous areas should not be considered part of the service area. To provide clarity, and in light of the expansion of the service area definition to include any area recognized as the service area under state or Federal law, the final regulations eliminate contiguous areas from the definition of service area.

Some commentators suggested that the definition of service area should be expanded to include any area "in which" (rather than "throughout which") the municipal utility provided service during the five-year period. To ensure that the gas or electricity is consumed by customers in an area recognized as the service area of a municipal utility under state or Federal law, or throughout which the municipal utility provided service during the five-year period, the final regulations do not adopt this comment.

2. Prepayments for Electricity

Some commentators suggested that the natural gas exception should be expanded to include prepayments for

electricity. These commentators stated that the restructuring of the electric power industry has affected municipal electric utilities in a manner that is similar to the effect that deregulation of the natural gas industry had on municipal gas utilities. These commentators stated that restructuring has threatened the ability of municipal electric utilities to obtain a secure supply of electric power on commercially reasonable terms, and that electric power prepayment transactions are necessary to obtain a guaranteed supply of electric power on favorable terms in light of restructuring.

The final regulations add an exception to the definition of investment-type property for certain electricity prepayments that are made by or for one or more municipal utilities (for example, if a joint action agency acquires electricity for one or more municipal electric utilities). The exception applies only if at least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. For this purpose, electricity is used for a qualifying use if it is to be: (1) furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or (2) sold to a municipal utility and

furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

3. Remedial Actions

The preamble to the proposed regulations states that issuers may apply principles similar to the rules of §1.141-12 to cure a violation of the use requirement. Commentators requested clarification regarding which remedies under §1.141-12 are available for this purpose. The final regulations provide that issuers may apply principles similar to the rules of §1.141-12 to cure a violation of the 90 percent use requirement, and that the "redemption or defeasance" remedy in §1.141-12(d) and the "alternative use of disposition proceeds" remedy in §1.141-12(e) are available for this purpose.

Some commentators requested clarification of the amount of nonqualified bonds that must be redeemed or defeased under the "redemption or defeasance" remedy. Under the final regulations, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141-7(d), treating nonqualified sales of gas or electricity as satisfying the benefits and burdens test under §1.141-7(c)(1). Commentators also suggested that the definition of

"nonqualified bonds" under §1.141-12 may require excessive amounts of bonds to be retired. The IRS and Treasury Department are considering this comment in connection with possible amendments to §1.141-12.

4. Commodity Swap Contracts

The proposed regulations provide that a transaction will not fail to qualify for the natural gas exception by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. For this purpose, the proposed regulations provide that a swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract). Notice 2002-52 (2002-30 I.R.B. 187), provides that a natural gas commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas supplier to deliver gas for which the swap contract is a hedge.

Commentators generally agreed with the provision on swap contracts in the proposed regulations, as modified by Notice 2002-52. The final regulations retain the provision on commodity swap contracts for natural gas prepayments, as modified by Notice 2002-52, and expand it to apply to electricity prepayments.

E. De minimis prepayments

The proposed regulations add an exception for prepayments made within 90 days of the date of delivery of all the property or services to which the prepayment relates. Commentators recommended that the exception apply based on reasonable expectations. The final regulations adopt this comment. This change to a reasonable expectations standard is intended to permit a prepayment to qualify for the de minimis exception even if an unexpected event beyond the control of the issuer causes delivery of the property or services to be delayed beyond the 90-day period. The reasonable expectations standard does not, however, apply to any change to the terms of the prepayment other than an unexpected delay in delivery.

II. Private Loans

The existing regulations, at §1.141-5(c)(2)(ii), provide rules for determining whether a prepayment for property or services is treated as a loan for purposes of the private loan

financing test. The existing regulations for private loans are similar to the existing regulations in §1.148-1(e)(2) for determining whether a prepayment gives rise to investment-type property, except that the private loan regulations focus on whether the prepayment provides a benefit of tax-exempt financing to the seller. The final regulations amend the private loan provisions of §1.141-5(c)(2) to conform to the amendments to the definition of investment-type property in the final regulations.

III. Tables of Contents

The final regulations amend the tables of contents in §§1.141-0 and 1.148-0 to reflect the final regulations and certain previously issued regulations under sections 141 and 148.

Effective Dates

The final regulations apply to bonds sold on or after October 3, 2003. In addition, issuers may apply the final regulations to bonds sold before October 3, 2003, that are subject to §§1.141-5 and 1.148-1.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required.

It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) do not apply.

Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal and Johanna Som de Cerff, Office of Chief Counsel (TE/GE), IRS, and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.141-0 is amended by revising the entry for §1.141-15(b) to read as follows:

§1.141-0 Table of contents.

* * * * *

§1.141-15 Effective dates.

* * * * *

(b) Effective dates.
(1) In general.
(2) Certain short-term arrangements.
(3) Certain prepayments.

* * * * *

Par. 3. In §1.141-5, paragraph (c)(2)(ii) is revised and paragraphs (c)(2)(iii) and (c)(2)(iv) are added to read as follows:

§1.141-5 Private loan financing test.

* * * * *

(c) * * *

(2) * * *

(ii) Certain prepayments treated as loans. Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if--

(A) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(B) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(C) The prepayment meets the requirements of §1.148-1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

(iii) Customary prepayments. The determination of whether a prepayment satisfies paragraph (c)(2)(ii)(A) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (c)(2)(ii)(A) of this section if--

(A) The prepayment is made for--

(1) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(2) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are

regularly provided to nongovernmental persons on the same terms.

(iv) Additional prepayments as permitted by the Commissioner. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

* * * * *

Par. 4. Section 1.141-15 is amended by adding paragraph (b)(3) to read as follows:

§1.141-15 Effective dates.

* * * * *

(b) * * *

(3) Certain prepayments. Except as provided in paragraph (c) of this section, paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of §1.141-5 apply to bonds sold on or after October 3, 2003. Issuers may apply paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of §1.141-5, in whole but not in part, to bonds sold before October 3, 2003, that are subject to §1.141-5.

Par. 5. Section 1.148-0 is amended by:

1. Adding entries in paragraph (c) for §1.148-1, paragraphs (e)(1) through (e)(3).

2. Adding entries in paragraph (c) for §1.148-11, paragraphs (b)(4), (h), (i) and (j).

The additions read as follows:

§1.148-0 Scope and table of contents.

* * * * *

(c) Table of contents.

* * * * *

§1.148-1 Definitions and elections.

* * * * *

(e) * * *
(1) In general.
(2) Prepayments.
(3) Certain hedges.

* * * * *

§1.148-11 Effective dates.

(b) * * *

(4) No elective retroactive application for safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.
* * * * *

(h) Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.
(i) Special rule for investments purchased for a yield restricted defeasance escrow.
(j) Certain prepayments.

Par. 6. In §1.148-1, paragraphs (e)(1) and (2) are revised to read as follows:

§1.148-1 Definitions and elections.

* * * * *

(e) Investment-type property--(1) In general. Investment-type property includes any property, other than property described in section 148(b)(2)(A), (B), (C) or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) Prepayments--(i) In general--(A) Generally. Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if--

(1) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(2) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(3) The prepayment meets the requirements of paragraph (e)(2)(iii)(A) or (B) of this section.

(B) Example. The following example illustrates an application of this paragraph (e)(2)(i):

Example. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

(ii) Customary prepayments. The determination of whether a prepayment satisfies paragraph (e)(2)(i)(A)(1) of this section is generally made based on all the facts and

circumstances. In addition, a prepayment is deemed to satisfy paragraph (e)(2)(i)(A)(1) of this section if--

(A) The prepayment is made for--

(1) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(2) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iii) Certain prepayments to acquire a supply of natural gas or electricity--(A) Natural gas prepayments. A prepayment meets the requirements of this paragraph (e)(2)(iii)(A) if--

(1) It is made by or for one or more utilities that are owned by a governmental person, as defined in §1.141-1(b) (each of which is referred to in this paragraph (e)(2)(iii)(A) as the issuing municipal utility), to purchase a supply of natural gas; and

(2) At least 90 percent of the prepaid natural gas financed by the issue is used for a qualifying use. Natural gas is used for a qualifying use if it is to be--

(i) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, provided, however, that gas used to produce electricity for sale shall not be included under this paragraph (e)(2)(iii)(A)(2)(i);

(ii) Used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility;

(iii) Used by the issuing municipal utility to produce electricity that will be sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser;

(iv) Sold to a utility that is owned by a governmental person if the requirements of paragraph (e)(2)(iii)(A)(2)(i), (ii) or (iii) of this section are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or

(v) Used to fuel the pipeline transportation of the prepaid gas supply acquired in accordance with this paragraph (e)(2)(iii)(A).

(B) Electricity prepayments. A prepayment meets the requirements of this paragraph (e)(2)(iii)(B) if--

(1) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(2) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be--

(i) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or

(ii) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

(C) Service area. For purposes of this paragraph (e)(2)(iii), the service area of a utility owned by a governmental person consists of--

(1) Any area throughout which the utility provided, at all times during the 5-year period ending on the issue date--

(i) In the case of a natural gas utility, natural gas transmission or distribution service; and

(ii) In the case of an electric utility, electricity distribution service; and

(2) Any area recognized as the service area of the utility under state or Federal law.

(D) Retail customer. For purposes of this paragraph (e)(2)(iii), a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale.

(E) Commodity swaps. A prepayment does not fail to meet the requirements of this paragraph (e)(2)(iii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas or electricity supplier), or between the gas or electricity supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas or electricity supply contract or another swap contract); provided, however, that a commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas or electricity supplier to deliver gas or electricity for which the swap contract is a hedge.

(F) Remedial action. Issuers may apply principles similar to the rules of §1.141-12, including §1.141-12(d) (relating to redemption or defeasance of nonqualified bonds) and §1.141-12(e) (relating to alternative use of disposition proceeds), to cure a violation of paragraph (e)(2)(iii)(A)(2) or (e)(2)(iii)(B)(2) of this section. For this purpose, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141-7(d), treating nonqualified sales of gas or electricity under this paragraph (e)(2)(iii) as satisfying the benefits and burdens test under §1.141-7(c)(1).

(iv) Additional prepayments as permitted by the Commissioner. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

* * * * *

Par. 7. Section 1.148-11 is amended by adding paragraph (j) to read as follows:

§1.148-11 Effective dates.

* * * * *

(j) Certain prepayments. Section 1.148-1(e)(1) and (2) apply to bonds sold on or after October 3, 2003. Issuers may apply §1.148-1(e)(1) and (2), in whole but not in part, to bonds sold before October 3, 2003, that are subject to §1.148-1.

Dale F. Hart,

Acting Deputy Commissioner for Services and Enforcement.

Approved: July 25, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 4, 2003
JS-630

Back from Jobs and Growth Tour, Snow heads to Hill to discuss ID theft

Treasury Secretary John Snow, who returned from a two day tour of the Midwest to discuss President Bush's efforts to create jobs and economic growth, will appear before the Senate Banking Committee to discuss identity theft and consumer credit issues.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 4, 2003
JS-631

Remarks by Kristin Smith, Director, Office of Financial Educaiton at the Wisconsin Institute for Financial and Economic Education Credit and Money Series in Madison, WI

I would like to thank Bill Wilcox of the CBM Credit Education Foundation for inviting the Treasury Department to participate in this morning's welcome ceremony. I would also like to congratulate Bill, David Mancl, the Wisconsin JumpStart Coalition, and the Wisconsin Department of Financial Institutions for organizing this important teacher training event and for all of the work that they have done to promote financial education in schools in Wisconsin.

At Treasury, we believe that the first step in improving financial education is getting the word out; the second step is providing resources that allow educators to teach the subject of financial education to their students. Equipping young people with an understanding of basic concepts like budgeting, saving, investing, and credit management will enable them to build financial security and make smart financial decisions throughout their lives. We applaud the organizers of this event who have gone above and beyond the call of duty to ensure that students in Wisconsin learn the basics of personal finance in elementary, middle, and high school, rather than through the school of hard knocks.

While this is my first trip to Wisconsin, the thing that comes to mind whenever I think of Madison is the fact that my dad, who was a banker in Philadelphia, attended banking school for several summers here in Madison. All of the things that my father learned as a banker - the importance of credit history, paying bills on time, living within a budget, etc. - carried over to his personal life and the way he managed our family finances. He taught my brother and me at a very early age the importance of managing our money well. My stepmother has pointed out that one of the things my father and I still have in common is our need to balance our checkbooks several times a week!

I was very lucky to have parents who taught me good money skills before I had the opportunity to make serious financial mistakes. By the time I entered college, I had a savings account, checking account, and ATM card, and understood how to use them. Like most college students, I immediately began receiving credit card offers and soon had several credit cards in my wallet.

Unlike some of my friends, however, I saw my credit cards as a tool to build a good credit history. I paid for my books at the campus bookstore, knowing that I was going to pay off the full balance as soon as the bill arrived. I admit that I used my credit cards to buy new clothes when I didn't really need them, but I could always here my dad's voice calculating the "real" cost of that new outfit if I decided to pay only the minimum balance

due on the next bill.

Many kids today are not as lucky as I was. Their parents may not have good personal finance knowledge or skills to pass along to their children. They may be living paycheck to paycheck or even teetering on the brink of bankruptcy. Other parents may not be comfortable talking about money with their kids. Surveys show that parents are more comfortable talking to their kids about sex than they are talking about money!

Yet it is more important now than ever to make sure that young people learn about personal finance. In 2001, teenagers spent more that $172 billion. More than twenty percent of teens have their own credit card. Individuals under the age of 25 are the fastest growing group of individuals filing for bankruptcy. The statistics tell us that we need to do something so that young people can begin their adult lives in good financial shape, not under the burden of unmanageable debt that keeps them from getting an education, buying a home, or even being hired for a good job.

As educators, you have an opportunity to make a real difference. By learning the basics of personal finance and passing this knowledge along to your students, you can help them avoid costly mistakes. The important role that educators play in improving financial education throughout the country is something that Treasury's Office of Financial Education has been thinking about since its creation.

The Department of the Treasury established the Office of Financial Education in May 2002. The Office focuses the Department's financial education policymaking, raises awareness about the need for and importance of financial education, and provides information about financial education resources throughout the Federal government. The OFE emphasizes four key areas of financial education: savings, credit management, homeownership, and retirement planning.

Some of the things that the OFE has been doing to fulfill its mission include chairing the Federal Government Financial Education Coordinating Group, which coordinates and encourages financial education efforts and expands cooperation among Federal agencies; highlighting effective financial education programs across the country, and co-hosting panel discussions with other Federal agencies to seek collective solutions to help consumers deal with specific financial education issues.

Most recently, we co-hosted with the Board of Governors of the Federal Reserve System a roundtable discussion on credit management. In May 2003, sixteen organizations representing credit card companies and the banking industry, credit and debt counseling services, and community and consumer groups participated in the event. We will be releasing shortly a top five list of credit management fundamentals that we all agree consumers can and should do to improve their credit.

Last year, our panel discussion was co-hosted by the Department of Education and focused on a topic that is very relevant to this week's program: integrating financial education into core curricula in grades K-12. What does this mean? It means that we think the best way for young people to receive financial education is by including personal finance concepts, such as the concept of compound interest or how to create a budget, when teaching other subjects, such as math or reading.

There are several advantages to approach. It provides a context for understanding personal finance concepts. It also enhances the teaching of these other subjects by providing real life examples that are meaningful to students. And, it makes financial education less susceptible to elimination because of budgetary cutbacks or scarce resources.

Last October, we released a white paper summarizing the discussion among the panel participants and highlighting its conclusions. The white paper goes into detail regarding the different means by which financial education can be incorporated into other subjects and includes the five access points identified during the discussion. These access points are: standards, testing, textbooks, financial education materials, and educators. We explain in the white paper how each of these access points can be used.

- Standards: In a standards-based education system, standards have a significant influence on what is taught in the classroom. Informing the state boards of education, which generally develop and adopt standards, about the importance of including financial education in the standards can help ensure that financial concepts are included in math and reading curricula.

- Testing: A standards-based education system uses testing to assess whether students are meeting academic standards. Because educators generally focus on subject matter that will be tested, including financial concepts in tests provides an incentive for teachers to teach the subject in the classroom.

- Textbooks: Publishers of textbooks and other instructional materials can be educated about the value of integrating financial concepts into other subjects, such as math and reading. Before purchasing instructional materials, states can impose requirements that publishers demonstrate how their materials incorporate financial concepts into other subjects.

- Financial education materials: There are ample financial education resources available on the Internet and from groups that produce or compile such materials. Many of these "off-the-shelf" materials can be incorporated into math and reading curricula to provide a financial education component to these subjects.

- Educators: Educator training and professional development requirements provide an opportunity to stress the importance of financial education to those individuals who are directly responsible for conveying such information to students.

We feel strongly that publicizing the process for curriculum development and providing guidance for utilizing these access points are important steps for Treasury. We hope that the white paper will continue to serve as a source of information and guidance that will influence policymakers, educators, and individuals to begin the long process of incorporating financial education into core curricula. And we believe that we are already having an impact.

Several state legislatures have already passed or are considering bills that would require personal finance be taught in schools. Even better, we've seen bills that specifically call for personal finance concepts to be integrated into other core subjects.

At the end of the day, we ask ourselves: can financial education make a difference? The answer to that question is yes. We know that individuals who have received financial education participate more frequently in, and make larger contributions to, employer 401(k) programs . . . that financial

education results in higher savings rates . . . and that individuals graduating from high schools in states that mandate a personal finance education course have higher savings rates and net worths than individuals in other states. That is why we continue our work to ensure that all Americans have access to the financial education programs and resources that they need to take full advantage of the opportunities offered by this country's great and diverse economy.

The Treasury Department is not the only federal government agency working to improve financial education. A wide variety of programs and resources are offered by entities like the U.S. Mint, the Federal Reserve System, the Treasury's Bureau of Public Debt, and the FDIC, just to name a few. These program and resources can help consumers with financial education issues ranging from opening a bank account to planning for retirement. The Office of Financial Education has been compiling a Federal resource directory that will be our website at www.treas.gov/financialeducation by mid-August.

In conclusion, I would like to thank you for your interest in improving financial education for students in Wisconsin. Working together, we can make a difference and ensure that young people have the knowledge and skills to effectively manage their financial lives. Enjoy the rest of the conference!

Related Documents:

- Powerpoint Presentation

Associated Links:

- Office of Financial Education

WELCOME

Wisconsin Institute for Financial
and Economic Education
Credit & Money Series
August 2003

Financial Education & the Federal Government

Kristin Smith
Director, Office of Financial Education
U.S. Department of the Treasury
www.treas.gov/financialeducation

Why Is Financial Education Important?

Helping people understand basic concepts such as managing money, budgeting, how to save and invest, and credit management provides them with the skills to build financial security and make good financial decisions throughout their lives.

Why Is Financial Education Important for Young People?

- In 2001 teenagers spent more than $172 billion.

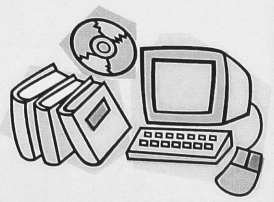
- More than 1 in 5 youths ages 12 to 19 have their own credit cards.

- The number of young Americans between the ages of 18 and 25 who declared bankruptcy in the 1990s nearly doubled from 60,180 in 1991 to 118,000 in 1999. In 2000, young people accounted for approximately 7% of the nation's personal bankruptcies.

**Statistics from different sources

U.S. Treasury Department Office of Financial Education

- Established in Spring 2002.
- Focuses the Treasury Department's financial education policymaking.
- Raises awareness about the need for financial education.
- Provides information about financial education resources throughout the federal government.



U.S. Treasury Department Office of Financial Education

Focuses on four key areas:

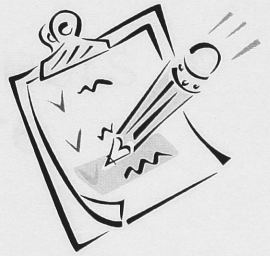
- ✓Basic Savings
- ✓Credit Management
- ✓Homeownership
- ✓Retirement Planning

What Is the Office of Financial Education Doing?

- ✓ Chairs the Federal Government Financial Education Coordinating Group (FGFECG)
- ✓ Coordinates and encourages financial education efforts, and expands cooperation among federal agencies
- ✓ Highlights effective financial education programs across the country according to criteria established by OFE

What Is the Office of Financial Education Doing?

- ✓ Co-hosted panel discussion with the Department of Education on integrating financial education into core curricula in grades K-12 and published an October 2002 white paper on the subject.



- ✓ Co-hosted credit management roundtable with the Federal Reserve and developed credit management fundamentals for consumers.

Why Teach Financial Education in Schools?

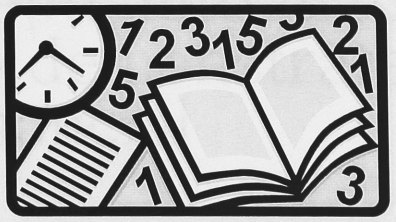
- The best way for young people to receive financial education is by including personal finance concepts (compounding interest or budgeting) when teaching math or reading.
- It enhances the teaching of these subjects by providing real life examples that are meaningful to students.
- When teaching personal finance skills in schools, we prepare young people to become competent consumers and informed managers of household wealth.

Integrating Financial Education Into Core Curricula

2002 White Paper

Key access points to ensure financial education is taught in schools:

- ❑ Standards Development Process
- ❑ Testing
- ❑ Text Books
- ❑ Financial Education Materials
- ❑ Educators



Integrating Financial Education Into Core Curricula

- Standards: Informing the state boards of education about the importance of personal finance can help ensure financial concepts are included in math and reading curricula.

- Testing: Including financial concepts in tests encourages teachers to teach the subject in the classroom.

- Textbooks: Educating publishers about the value of integrating financial concepts into math and reading, and requiring them to demonstrate how their materials incorporate financial concepts into other subjects.

Integrating Financial Education Into Core Curricula

- Financial Education Materials: Incorporating on-line materials into math and reading curricula to provide a financial education component to these subjects.

- Educators: Training and professional development requirements should stress the importance of financial education so that teachers can convey such information to students.

Personal Finance Education State Legislation

- Colorado House Joint Resolution 03-1069: Concerning the importance of personal financial literacy.
- Montana House Joint Resolution 10: Urging the board of public education to integrate the principles of basic personal finance into the content and performance standards established for Montana's public schools.
- Texas House Concurrent Resolution 15: Directing the State Board of Education to implement the inclusion of elements relating to personal finance among the essential knowledge and skills in the required public school curriculum

Financial Education Effectiveness

- High school graduates from states that mandated a personal finance education course have higher savings rates than individuals in other states
- Individuals who have received financial education participate more frequently in, and make larger contributions to, employer 401(k) programs

The Need for Financial Education Today

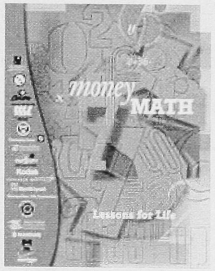
- Americans are presented with complex financial choices requiring them to select from a rich diversity of financial products and services.
- All Americans need to be prepared and financially educated to take full advantage of these opportunities.
- When individuals fulfill their potential, there is an overall impact on the nation's economy.

Federal Government Financial Education Programs

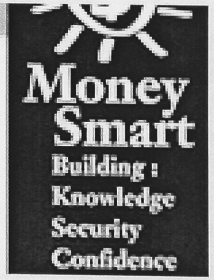
H.I.P. Pocket Change
Treasury Department - U.S. Mint

Personal Financial Education
Federal Reserve Bank

Money Math: Lessons for Life
Treasury Department - BPD



Money Smart
Federal Deposit Insurance Corporation



Additional Resources

www.treas.gov/financialeducation

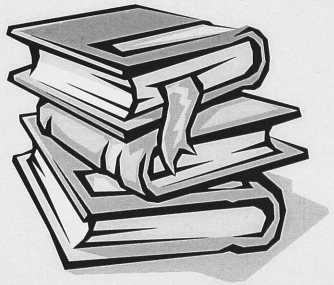
www.sec.gov/investor/pubs/roadmap.htm

www.irs.gov/app/understandingTaxes/

www.reeusda.gov/ecs/cfe.htm

www.ed.gov/index.jsp

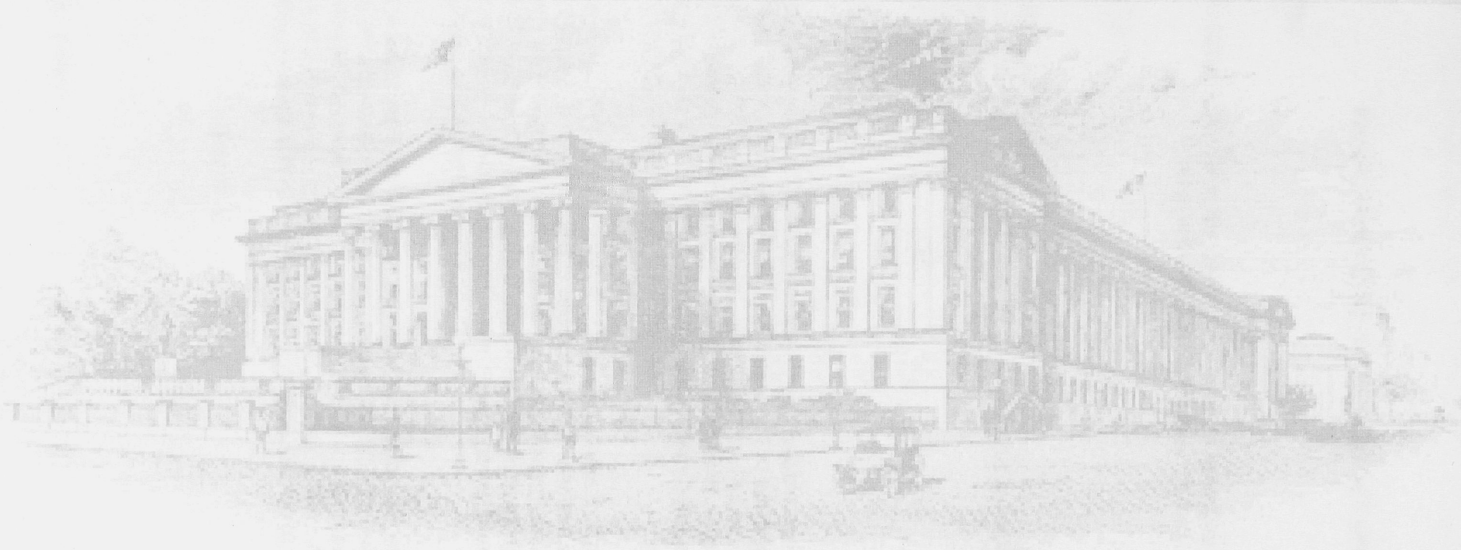
www.pueblo.gsa.gov



...Conclusion

Working together, we can make a difference and ensure that young people have the knowledge and skills to effectively manage their financial lives.

Thank You



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
JS-633

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 30, 2003
JS-634

Treasury Letter to Congress on CSRDF Restoration Following Debt Issuance Suspension

July 30, 2003

The Honorable J. Dennis Hastert
Speaker of the House
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Speaker:

On December 24, 2002, Treasury informed Congress that the public debt outstanding would reach the statutory limit of $6.4 trillion in the latter half of February 2003. The public debt outstanding first reached the statutory limit on February 20, 2003, and beginning on that date and thereafter, Treasury suspended additional investments of the Government Securities Investment Fund, as necessary, and took other lawful actions in order to keep from exceeding the statutory limit. On April 4, 2003, Treasury informed Congress that a "debt issuance suspension period" would begin as early as April 4, but not later than April 11, and last until July 11, 2003. Subsequently, on May 19, 2003, the "debt issuance suspension period" was extended from July 11 to December 19, 2003. From April 8 through May 27, 2003, outstanding Treasury debt would have exceeded the statutory limit if the Secretary of the Treasury had not taken actions relating to the investment of assets of the Civil Service Retirement and Disability Fund (CSRDF). This is the report required by section 8348 of Title 5, United States Code, concerning the operation and status of the CSRDF during the recent debt issuance suspension period.[1] As explained below, the CSRDF has been fully restored.

Section 8348(j)(1) authorizes the Secretary to suspend the issuance of obligations to the CSRDF if new obligations could not be issued without exceeding the public debt limit. In addition, if the Secretary determines that a "debt issuance suspension period" exists, he is authorized by section 8348(k)(1) and (2) to sell or redeem securities held by the CSRDF to obtain any amount of funds not exceeding an amount equal to the total amount of the benefit and other payments authorized to be made from the CSRDF during the debt issuance suspension period.

On April 8, 2003 and May 20, 2003, investments[2] of the CSRDF were redeemed in order to prevent the public debt from exceeding the statutory limit. During the debt issuance suspension period, the CSRDF also received funds that could not be invested without exceeding the debt limit. CSRDF receipts received between April 8 and May 27 totaling $2,541,232,000 remained uninvested.

Section 8348(j)(3) requires the Secretary, upon expiration of a debt issuance suspension period, to issue to the CSRDF obligations that will ensure that the holdings of the fund replicate to the maximum extent practicable the obligations the

fund would have held upon the expiration of the debt issuance suspension period if the debt issuance suspension period had not occurred. Section 8348(j)(4) requires the Secretary to pay to the CSRDF on the first normal interest payment date following the expiration of a debt issuance suspension period the amount of interest that would have been earned by the CSRDF if the debt issuance suspension period had not occurred.

On May 27, 2003, the debt issuance suspension period ended when the President signed legislation increasing the permanent debt limit to $7.384 trillion (P.L. 108-24). In order to place the CSRDF in the same financial position it would have been in had there not been a debt issuance suspension period, the following actions were taken on May 27 and June 30, the first normal interest payment date following the expiration of the debt issuance suspension period.

- On May 27:
  1. Uninvested receipts of the CSRDF totaling $2,541,232,000 were invested in a 4% certificate of indebtedness maturing June 30, 2003.
  2. Principal amounts of the 5¼% bond redeemed and not otherwise used for benefit payments during the debt issuance suspension period totaling $28,290,099,000 were invested in a 5¼% bond maturing June 30, 2017.
  3. A certificate of indebtedness maturing June 30, 2003 was redeemed with interest and principal totaling about $4,109,901,000. A principal amount of $4,109,901,000 was invested in the 5¼% bond maturing June 30, 2017.[3]

- On June 30:
  1. Interest totaling $100,822,854.44, representing the amount that would have been earned, but for the debt issuance suspension period, was paid and invested. This represents interest lost from the early redemption of the 5¼% bond on April 8 and May 20 and interest on receipts uninvested between April 8 and May 27. Based on these actions, the CSRDF has been fully restored to the condition in which it would have been had there not been a debt issuance suspension period.

Sincerely,

Brian Roseboro
Assistant Secretary for
Financial Markets

Letter sent to:
Rep. Hastert Speaker of the House
Rep. DeLay House Majority Leader
Rep. Pelosi House Minority Leader
Rep. Thomas Ways & Means Committee, Chairman
Rep. Rangel Ways & Means Committee, Ranking Member
Rep. Nussle - Budget Committee, Chairman
Rep. Spratt - Budget Committee, Ranking Member
Rep. Oxley Financial Services Committee, Chairman
Rep. Frank Financial Services Committee, Ranking Member
Rep. Davis - Government Reform Committee, Chairman
Rep. Waxman - Government Reform Committee, Ranking Member
Sen. Frist - Senate Majority Leader
Sen. Daschle - Senate Minority Leader
Sen. Stevens President Pro Tempore of the Senate
Sen. Grassley - Finance Committee, Chairman
Sen. Baucus - Finance Committee, Ranking Member
Sen. Shelby Banking, Housing, and Urban Affairs Committee, Chairman
Sen. Sarbanes - Banking, Housing, and Urban Affairs Committee, Ranking Member
Sen. Nickles Budget Committee, Chairman
Sen. Conrad Budget Committee, Ranking Member

Sen. Collins - Governmental Affairs Committee, Chairman
Sen. Lieberman Governmental Affairs Committee, Ranking Member

[1] A similar report covering the operation and status of the Government Securities Investment Fund of the federal employees' Thrift Savings Plan was submitted to Congress on June 27, 2003.

[2] Par Value: $12,150,000,000; Maturity: June 30, 2017; Interest Rate: 5¼%; Redeemed April 8, 2003. Par Value: $20,250,000,000; Maturity: June 30, 2017; Interest Rate: 5¼%; Redeemed May 20, 2003.

[3] This represents principal from the bonds redeemed on April 18 and May 20 and used to make the benefit payments during the DISP (May 1, 2003 - $3,959,209,000; May 7, 2003 - $75,346,000; and May 8, 2003 - $75,346, 000). Had the DISP not occurred, these payments would have been properly paid through the redemption of certificates of indebtedness.

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.
August 4, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $17,000 million to refund an estimated $17,000 million of publicly held 4-week Treasury bills maturing August 7, 2003.

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 $13,722 million of the Treasury bills maturing on August 7, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

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

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

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

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

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

oOo

Attachment

JS 635

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED AUGUST 7, 2003

August 4, 2003

Offering Amount	$17,000 million
Maximum Award (35% of Offering Amount)	$ 5,950 million
Maximum Recognized Bid at a Single Rate	$ 5,950 million
NLP Reporting Threshold	$ 5,950 million
NLP Exclusion Amount	$11,800 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 NL 1
Auction date	August 5, 2003
Issue date	August 7, 2003
Maturity date	September 4, 2003
Original issue date	March 6, 2003
Currently outstanding	$45,827 million
Minimum bid amount and multiples	$1,000

Submission of Bids:

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

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

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

Noncompetitive tenders:

Prior to 11:00 a.m. eastern daylight saving time on auction day

Competitive tenders:

Prior to 11:30 a.m. eastern daylight saving time on auction day

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

PUBLIC DEBT NEWS

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

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

FOR IMMEDIATE RELEASE
August 05, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	August 07, 2003
Maturity Date:	September 04, 2003
CUSIP Number:	912795NL1

High Rate: 0.915% Investment Rate 1/: 0.929% Price: 99.929

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 37.78%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 45,025,190	$ 16,965,553
Noncompetitive	34,771	34,771
FIMA (noncompetitive)	0	0
SUBTOTAL	45,059,961	17,000,324
Federal Reserve	2,831,774	2,831,774
TOTAL	$ 47,891,735	$ 19,832,098

Median rate 0.910%: 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 = 45,059,961 / 17,000,324 = 2.65

1/ Equivalent coupon-issue yield.

TS 636

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
August 05, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 3-YEAR NOTES

Interest Rate:	2 3/8%	Issue Date:	August 15, 2003
Series:	H-2006	Dated Date:	August 15, 2003
CUSIP No:	912828BF6	Maturity Date:	August 15, 2006

High Yield: 2.422% Price: 99.865

All noncompetitive and successful competitive bidders were awarded securities at the high yield. Tenders at the high yield were allotted 65.84%. All tenders at lower yields were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 31,297,000	$ 23,722,040
Noncompetitive	278,013	278,013
FIMA (noncompetitive)	0	0
SUBTOTAL	31,575,013	24,000,053 1/
Federal Reserve	3,906,967	3,906,967
TOTAL	$ 35,481,980	$ 27,907,020

Median yield 2.350%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low yield 2.250%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 31,575,013 / 24,000,053 = 1.32

1/ Awards to TREASURY DIRECT = $175,360,000

JS 637

federal financing bank NEW

WASHINGTON, D.C. 20220

FEDERAL FINANCING BANK

2003 PRESS RELEASE

August 2003

Brian Jackson, Chief Financial Officer, Federal Financing Bank (FFB) announced the following activity for the month of August 2003.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $36.4 billion on August 31, 2003, posting a decrease of $101.9 million from the level on July 31, 2003. This net change was the result of decreases in holdings of agency assets of $95.0 million and in holdings of government-guaranteed loans of $6.9 million. The FFB made 41 disbursements and received 35 prepayments during the month of August. The FFB also priced 8 buy-downs of loans guaranteed by the Rural Utilities Service ("RUB") during the month.

Below are tables presenting FFB August loan activity and FFB holdings as of August 31, 2003.

PRINT

FEDERAL FINANCING BANK
August 2003 ACTIVITY

Borrower	*Date*	*Amount of Advance*	*Final Maturity*	*Interest Rate*	*Semi-Annually or Quarterly*
U.S. POSTAL SERVICE					
U.S. Postal Service	8/01	$546,900,000.00	8/4/2003	1.061%	Semi-Annually
U.S. Postal Service	8/04	$546,900,000.00	8/5/2003	1.030%	Semi-Annually
U.S. Postal Service	8/05	$546,900,000.00	8/6/2003	1.030%	Semi-Annually

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U.S. Postal Service	8/06	$546,900,000.00	8/7/2003	1.030%	Semi-Annually
U.S. Postal Service	8/07	$150,000,000.00	2/17/2004	1.195%	Semi-Annually
U.S. Postal Service	8/07	$100,000,000.00	2/17/2004	1.195%	Semi-Annually
U.S. Postal Service	8/07	$1,000,000,000.00	8/15/2003	1.083%	Semi-Annually
U.S. Postal Service	8/07	$750,000,000.00	8/15/2003	1.051%	Semi-Annually
U.S. Postal Service	8/07	$2,000,000,000.00	2/5/2004	1.167%	Semi-Annually
U.S. Postal Service	8/07	$2,523,437,000.00	8/20/2003	1.051%	Semi-Annually
U.S. Postal Service	8/15	$1,000,000,000.00	11/17/2003	1.084%	Semi-Annually
U.S. Postal Service	8/15	$750,000,000.00	11/17/2003	1.084%	Semi-Annually
U.S. Postal Service	8/20	$2,523,437,000.00	9/4/2003	1.091%	Semi-Annually
GOVERNMENT-GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
Foley Services Contract	8/14	$63,404.49	7/31/2025	5.204%	Semi-Annually
Foley Services Contract	8/14	$96,425.24	7/31/2025	5.204%	Semi-Annually
Foley Services Contract	8/14	$157,554.85	7/31/2025	5.204%	Semi-Annually
San Francisco Bldg Lease	8/27	$3,665,169.76	8/1/2005	2.048%	Semi-Annually
San Francisco OB	8/28	$133,986.72	8/1/2005	2.137%	Semi-Annually
DEPARTMENT OF EDUCATION					
Tuskegee Univ.	8/06	$1,122,819.12	1/2/2032	5.228%	Semi-Annually
RURAL UTILITIES SERVICE					
Planters Electric #763	8/01	$840,000.00	12/31/2030	5.148%	Quarterly
Goodhue County #672	8/06	$410,000.00	3/31/2004	1.131%	Quarterly
Pee Dee Elec. #547	8/06	$984,000.00	1/2/2007	2.625%	Quarterly
Farmers Elec Coop Corp #877	8/07	$680,000.00	1/2/2035	5.111%	Quarterly
Tri-State E.M.C. #730	8/07	$1,000,000.00	1/2/2035	5.110%	Quarterly
Sac Osage Electric Coop. #815	8/08	$554,000.00	12/31/2036	5.116%	Quarterly
San Patricio Elec. #676	8/08	$1,182,000.00	1/2/2035	5.080%	Quarterly
Frontier Power #667	8/11	$967,000.00	1/2/2035	5.083%	Quarterly
Interstate Tele #661	8/12	$1,573,656.00	12/31/2019	4.287%	Quarterly
@French Broad Elec. #245	8/15	$507,193.17	1/2/2018	4.488%	Quarterly
@French Broad Elec. #245	8/15	$179,078.79	12/31/2018	4.595%	Quarterly
@French Broad Elec. #245	8/15	$792,385.16	12/31/2018	4.595%	Quarterly
@French Broad Elec. #245	8/15	$512,558.22	12/31/2018	4.595%	Quarterly
@French Broad Elec. #245	8/15	$250,229.92	12/31/2018	4.595%	Quarterly
@French Broad Elec. #245	8/15	$90,792.64	12/31/2018	4.595%	Quarterly
@French Broad Elec. #245	8/15	$283,527.08	12/31/2018	4.595%	Quarterly
@French Broad Elec. #245	8/15	$120,576.07	12/31/2018	4.595%	Quarterly
Nolin Rural Elec. #840	8/15	$2,948,000.00	12/31/2003	0.992%	Quarterly
Swan's Island Electric #203	8/15	$23,000.00	12/31/2036	5.325%	Quarterly
Wild Rice Elec. #806	8/15	$279,000.00	12/31/2035	5.307%	Quarterly
Moreau-Grand #569	8/18	$184,800.00	1/3/2034	6.055%	Quarterly

Buggs Island Telephone #204	8/19	$1,039,000.00	12/31/2019	4.544%	Quarterly
Rio Grand Electric #615	8/19	$525,000.00	1/3/2034	5.220%	Quarterly
North Central Elec Coop. #201	8/21	$490,000.00	12/31/2036	5.209%	Quarterly
Cotton Electric Coop #203	8/22	$1,526,000.00	12/31/2037	5.259%	Quarterly
Central Georgia Elec. #201	8/25	$1,823,000.00	9/30/2013	4.402%	Quarterly
Pointe Coupee Electric #204	8/25	$850,000.00	12/31/2037	5.060%	Quarterly
East Kentucky Power #489	8/26	$3,938,000.00	12/31/2024	5.055%	Quarterly
Southern Iowa Electric #204	8/26	$1,500,000.00	12/31/2037	5.253%	Quarterly
Sangre De Cristo Elec. #732	8/28	$500,000.00	9/30/2008	3.527%	Quarterly
@ interest rate buydown					

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FEDERAL FINANCING BANK HOLDINGS
AUGUST 2003

(in millions of dollars)

Program	*FEDERAL FINANCING August 31, 2003*	*BANK HOLDINGS July 31, 2003*	*Monthly Net Change 8/1/03- 8/31/03*	*Fiscal Year Net Change 10/1/02- 8/31/03*
Agency Debt:				
U.S. Postal Service	$7,273.4	$7,273.40	$0.00	($3,840.60)
Subtotal*	$7.273.4	$7,273.40	$0.00	($3,840.60)
Agency Assets:				
FmHA-RDIF	$855.00	$950.00	($95.00)	($95.00)
FmHA-RHIF	$2,530.00	$2,530.00	$0.00	($375.00)
Rural Utilities Service-CBO	$4.270.2	$4,270.20	$0.00	$0.00
Subtotal*	$7,655.20	$7,750.20	($95.00)	($470.00)
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	$1,706.10	$1,739.70	($33.70)	($216.50)
DoEd-HBCU+	$79.10	$78.00	$1.10	$10.00
DMUD-Comm Dev. Block Grant	$2.00	$3.20	($0.40)	($2.30)
DHUD-Public Housing Notes	$1,133.2	$1,133.20	$0.00	($74.10)
General Services Administration+	$2,150.10	$2,146.00	$4.10	($55.50)
DOI-Virgin Islands	$9.60	$9.60	$0.00	($1.80)
DON-Ship Lease Financing	$607.00	$607.50	$0.00	($173.30)
Rural Utilities Service	$1,720.70	$1,696.90	$23.00	$1,662.50
SBA-State/Local Devel Cos.	$79.00	$80.90	($1.90)	($23.40)
DOT-Section 511	$3.10	$3.10	$0.00	($0.10)
Subtotal*	$21,491.20	$21,498.10	($6.90)	$1,126.10
Grand total*	**$36,419.00**	**$36,521.70**	**($101.90)**	**($3,184.50)**

figures may not total due to rounding; +does not include capitalized interest

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Last Updated on 1/22/04

FROM THE OFFICE OF PUBLIC AFFAIRS

August 5, 2003
2003-8-5-16-48-46-26801

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 $80,694 million as of the end of that week, compared to $81,757 million as of the end of the prior week.

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

	July 25, 2003			August 1, 2003		
TOTAL		81,757			80,694	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	7,649	13,238	20,887	7,450	13,108	20,558
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,471	2,658	15,129	12,193	2,632	14,825
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]			23,086			22,800
3. Special Drawing Rights (SDRs) [2]			11,611			11,468
4. Gold Stock [3]			11,044			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	July 25, 2003			August 1, 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:

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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 25, 2003			August 1, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions Headquartered in the U.S.						
3.c. With banks and other financial institutions Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

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

Reserves for the prior week are final.

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

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

FROM THE OFFICE OF PUBLIC AFFAIRS

August 5, 2003
JS-640

J. Snow, D. Evans & E. Chao: Why we came to Wisconsin and Minnesota

John Snow, Don Evans and Elaine Chao

Published 08/05/2003

Last week, we traveled together through Wisconsin and Minnesota to see the American economy in action. In Wisconsin, we met with workers and chief executives in Milwaukee, small-business leaders at a forklift sales and servicing company in Green Bay, and families at a Culver's in Mosinee. In Minnesota, we met health care professionals and students at the Mayo Clinic in Rochester, investors in St. Paul, and retail workers at a Best Buy in Richfield. In Milwaukee, we were so enthusiastic for the workers and product at the Harley Davidson motorcycle manufacturing plant that our two-state bus tour nearly became a two-wheeled bike tour.

At each of our stops, we were impressed with the energy and optimism of the American people. Folks have been weathering a slower economy the past few years, but there is a general sense that it's improving and even better days are ahead. With the implementation of the president's Jobs and Growth Plan, working families are getting the relief they've earned, and businesses and entrepreneurs are beginning to act on plans to create new jobs and increase output. In fact, more than 3.5 million taxpayers in these two states are now enjoying higher disposable income thanks to the president's plan. They are putting that money to work for themselves, their families and for this economy.

For families, the first child tax credit checks have already been mailed. July marked the start of more generous paycheck withholding tables and the end of the marriage penalty. The people we met were taking notice.

On the supply side, investors and business leaders are beginning to realize the benefits of lower dividend and capital gains taxes. Small businesses in particular are cheering the higher expensing limits for new equipment purchases. These lower taxes on capital are encouraging investment and smarter allocation of resources. In more and more cases, that means large companies are returning cash to shareholders, instead of retaining earnings indefinitely. For companies of all sizes, it means taking long-standing capital spending plans off the shelf, and putting them into action.

And we talked to workers taking advantage of training programs in the health care sector, which is one of the fastest-growing sectors in the 21st-century workforce. By the year 2010, there will be more than 1 million job openings for registered nurses alone.

There are a lot of stories like these in our nation's economy right now, in Wisconsin, Minnesota and in every state. The president's Jobs and Growth Plan is making a difference, encouraging people to push forward with spending and investment plans, plans that will ultimately boost growth and create new jobs throughout this country.

Treasury Secretary John Snow, Commerce Secretary Don Evans and Labor Secretary Elaine Chao are members of President Bush's Cabinet.

Bureau of the Public Debt
United States Department of the Treasury

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

FOR IMMEDIATE RELEASE

August 6, 2003

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

	In Thousands
Principal Outstanding (Eligible Securities)	$2,393,375,777
Held in Unstripped Form	$2,215,818,315
Held in Stripped Form	$177,557,462
Reconstituted in July	$20,192,559

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

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

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FROM THE OFFICE OF PUBLIC AFFAIRS

August 6, 2003
JS-642

Rob Nichols Sworn in as Assistant Secretary for Public Affairs

Treasury Secretary John Snow today swore in Rob Nichols as Assistant Secretary for Public Affairs. Nominated for the position by President George W. Bush on April 10, 2003, Nichols was confirmed by the United States Senate on August 1, 2003.

As Assistant Secretary for Public Affairs, Nichols will play 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 the U.S. economy. In addition to serving as the chief spokesman for the Treasury Department and Secretary John Snow, Nichols also will design and implement policies, communications strategies, and programs that will increase the public's knowledge and understanding of Treasury's activities and services among the news media, business groups, consumer groups, and other government agencies.

In his new role, Nichols also will oversee the Office of Public Liaison, which conducts outreach to business, advocacy and financial communities, including Wall Street; elicits information, analysis and opinions from public and private organizations representing business and consumer interests; and communicates Treasury and Bush Administration views to these entities.

Since the beginning of the Bush Administration, Nichols has served as Deputy Assistant Secretary for Public Affairs. In that position, Nichols was responsible for media relations for the Department of the Treasury. This involved planning strategies on how to present issues to the media; representing senior Treasury officials to the media; providing tactical communications counsel; acting as a Treasury spokesman; and representing the Bush Administration's views on issues to the press, and through them, to the general public. On a day-to-day basis, Nichols arranged interviews, press conferences, background briefings, photo opportunities, and responded to questions from the media.

Before joining the Department of the Treasury, Nichols served as Communications Director for the Electronic Industries Alliance. Previously, he served as Communications Director for Senator Slade Gorton and as Press Secretary for Congresswoman Jennifer Dunn. Earlier in his career, Nichols was the Political Director for the Washington State Republican Party. During the George H.W. Bush administration, he worked at the White House as an aide in the Office of the Chief of Staff, and at the Department of Transportation in the Office of the Secretary. A native of Seattle, Washington, Nichols is a graduate of George Washington University.

He resides in Washington, D.C. with his wife Rebecca.

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
August 06, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Interest Rate:	3 1/4%	Issue Date:	August 15, 2003
Series:	G-2008	Dated Date:	August 15, 2003
CUSIP No:	912828BG4	Maturity Date:	August 15, 2008

High Yield: 3.300% Price: 99.771

All noncompetitive and successful competitive bidders were awarded securities at the high yield. Tenders at the high yield were allotted 35.75%. All tenders at lower yields were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 44,474,005	$ 17,763,294
Noncompetitive	236,878	236,878
FIMA (noncompetitive)	0	0
SUBTOTAL	44,710,883	18,000,172 1/
Federal Reserve	3,353,619	3,353,619
TOTAL	$ 48,064,502	$ 21,353,791

Median yield 3.278%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low yield 3.200%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 44,710,883 / 18,000,172 = 2.48

1/ Awards to TREASURY DIRECT = $115,506,000

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PUBLIC DEBT NEWS

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

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

FOR IMMEDIATE RELEASE
August 07, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 10-YEAR NOTES

Interest Rate:	4 1/4%	Issue Date:	August 15, 2003
Series:	D-2013	Dated Date:	August 15, 2003
CUSIP No:	912828BH2	Maturity Date:	August 15, 2013

High Yield: 4.370% Price: 99.036

All noncompetitive and successful competitive bidders were awarded securities at the high yield. Tenders at the high yield were allotted 82.62%. All tenders at lower yields were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 35,735,825	$ 17,760,269
Noncompetitive	239,733	239,733
FIMA (noncompetitive)	0	0
SUBTOTAL	35,975,558	18,000,002 1/
Federal Reserve	2,515,214	2,515,214
TOTAL	$ 38,490,772	$ 20,515,216

Median yield 4.310%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low yield 4.250%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 35,975,558 / 18,000,002 = 2.00

1/ Awards to TREASURY DIRECT = $117,103,000

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DEPARTMENT OF THE TREASURY

TREASURY NEWS

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

EMBARGOED UNTIL 11:00 A.M.
August 7, 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 $29,884 million of publicly held 13-week and 26-week Treasury bills maturing August 14, 2003, and to raise new cash of approximately $2,116 million. Also maturing is an estimated $8,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced August 11, 2003.

The Federal Reserve System holds $13,481 million of the Treasury bills maturing on August 14, 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 August 12, 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 $1,095 million into the 13-week bill and $811 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-645

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED AUGUST 14, 2003

August 7, 2003

Offering Amount	$16,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$5,600 million	$5,600 million
Maximum Recognized Bid at a Single Rate	$5,600 million	$5,600 million
NLP Reporting Threshold	$5,600 million	$5,600 million
NLP Exclusion Amount	$4,900 million	None
Description of Offering:		
Term and type of security	91-day bill	182-day bill
CUSIP number	912795 NW 7	912795 PK 1
Auction date	August 11, 2003	August 11, 2003
Issue date	August 14, 2003	August 14, 2003
Maturity date	November 13, 2003	February 12, 2004
Original issue date	May 15, 2003	August 14, 2003
Currently outstanding	$19,272 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 8, 2003
JS-646

U.S. Treasury Announces U.S.-Brazil Group for Growth Meeting

WASHINGTON, DC – At the time of the meeting of President Lula with President Bush on June 20, 2003, Secretary Snow and Minister Palocci launched a Group for Growth designed to examine strategies for raising productivity growth.

This group, chaired for the U.S. side by John B. Taylor, Under Secretary for International Affairs at the U.S. Treasury, and for the Brazilian side by Joaquim V. Levy, Secretary of the National Treasury, and Marcos Lisboa, Secretary for Economic Policy, both at the Brazilian Ministry of Finance, will hold its first meeting in Washington D.C. on August 27, 2003.

During the meeting, the Brazilian and U.S. delegations will hold a seminar on determinants of growth and measures to boost small- and medium-sized enterprises, including access to credit and capital markets. The meeting will also offer a venue for each side to present an overview on recent growth performance and discuss recent trends and prospects in the fiscal area.

Both countries are putting in place policies to raise growth, with voting on key reform legislation in Brazil and the implementation of major jobs and growth legislation in the United States. Closer understanding of the underpinnings of economic activity and reforms in each country is thus of mutual interest.

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 11, 2003
JS-647

Presentation of Terrorism Risk Insurance Program Executive Director Jeffrey Bragg To the Vermont Captive Insurance Association

Slide 1: Introduction

Slide 2:

Good afternoon and thank you for the opportunity to speak to you today on Treasury's progress and plans for implementing the Terrorism Risk Insurance Act of 2002, otherwise referred to as TRIA.

On November 26, 2002, President Bush signed TRIA into law.

With an estimated $40B in insured losses as a result of the events of 9/11 the market for terrorism coverage became severely disrupted.

However in addition to wanting to address Insurance industry disruptions, the Congress and the President recognized that such wide spread dislocations in insurance markets also had a negative impact on business' ability to finance economic activity and recovery.

TRIA was therefore enacted to stabilize the availability of insurance protection as well as to stabilize the overall economy.

Slide 3:

TRIA effectively places the Federal Government temporarily in the terrorism risk reinsurance business:

The program provides coverage for commercial lines P&C losses including workers' compensation.

Coverage is triggered when the Secretary of the Treasury the Secretary of State and the Attorney General together certify that an act of terrorism carried out on behalf of a foreign interest has occurred:

This terrorism generated loss must be greater than $5M

And. the event must have taken place in the US, or a US foreign mission, or on a US air carrier or vessel.

Slide 4:

One of the first things that had to be defined under the act was what constitutes a P&C insurer.

This task was more difficult than it first appeared. However "Insurer" for purposes of the act is any entity that is:

Licensed or admitted for primary or excess insurance in any state

A surplus lines carrier on the quarterly NAIC listing of alien insurers

Insurers approved by a federal agency in connection with maritime, energy, or aviation activity

A State residual market or workers compensation fund

Altogether well over 2000 insurance companies are participating in the program.

But understandably programs with current federal exposure like the National Flood Insurance Program are not included.

Also insurance products including assumed reinsurance, health and life insurance and for now group life insurance are excluded from the program.

Slide 5:

Like any program there are restrictions.

Deductibles increase over the 3 year term of the program and are expressed as a percent of an insurer's direct earned premium.

The Federal Governments share under the program is equal to 90% of that portion of insured losses that exceed the insurer deductible.

While there is a cap on total insured losses: if total losses exceed the cap Congress will determine the procedures for and source of payments for those excess losses.

The program is scheduled to end on December 31, 2005

Many of you here today believe that all federal programs last forever. However the Former Riot Reinsurance Program and the Former Federal Crime Insurance Program are 2 examples of government insurance mechanisms that have been discontinued when it became clear that their temporary mission had been fulfilled.

Slide 6:

There are provisions under the act whereby the Secretary can recoup certain government payments

Mandatory recoupment is triggered whenever there is a loss and the insurance industry paid losses are less than that year's industry retention.

The annual industry retention is equal to the lesser of a dollar amount which was fixed by Congress or the actual aggregate insured losses.

Aggregate Insured losses are all the losses associated with an act of terrorism that are within an insurer's deductible and the 10% of insured loss quota share.

Under mandatory recoupment The Secretary will establish Terrorism Loss Risk Sharing Premiums of up to a 3% surcharge on all commercial policy premiums

In addition The Secretary can depending on economic conditions impose an additional discretionary recoupment program whereby additional surcharges on

insurance premiums can be collected.

Slide 7:

To illustrate lets assume there is a $20B covered loss during the 3rd year of the program

This Loss is greater than the insurance industry's maximum aggregate retention that year of $15B.

Further assume that 100 insurance companies were exposed to that loss and that their collective direct earned premiums totaled $20B.

The third year deductible of 15% equals $3B for these 100 companies and their 10% quota share equals another $1.7B making the 100 insurer's share of the total paid losses for the companies involved $4.7B.

Under this example Treasury would pay $15.3B, which is the difference between the total insured loss and the losses paid by the 100 involved companies.

However, under the law Treasury is required to recoup $10.3B which is the difference between the industry aggregate retention of $15B and the $4.7B paid by the 100 companies.

To accomplish this all companies covered under the program would impose up to a 3% premium surcharge on all commercial policy holders until $10.3B had been recouped and paid to Treasury.

Additionally depending on economic considerations the Secretary of the Treasury has discretionary authority to impose additional recoupment surcharges and could recoup up to the entire $20B loss.

Slide 8:

The Terrorism Risk Insurance Program or T.R.I.P. is itself under Treasury's Department for Domestic Finance (headed by Under Secretary Peter Fisher) and the Office of Financial Institutions (headed by Assistant Secretary Wayne Abernathy).

TRIP's responsibilities include all of the operational functions necessary to effectively implement and manage the program, including all claims management and processing functions, as well as all auditing functions

TRIP is in essence the insurance company created by the new law.

However 2 additional Treasury offices play an important part in the program.

Treasury's Office of Economic Policy will be conducting studies associated with coverage issue under TRIA and the overall effectiveness of the program.

The office of Financial Institutions Policy has been responsible for promulgating rules and regulations for the program and will continue to assist TRIP in rule making as we move to the operational phase of the program.

Slide 9:

Already substantial progress has been made in implementing the program

The Office of Financial Institutions Policy has been extremely active in

implementing the regulations necessary to support the new act.

They have issued

- 4 interim guidance notices
- 2 interim final rules
- 1 notice of proposed rulemaking
- A final rule.

Slide 10:

The final rule published in the federal register on July 11 sets forth key definitions that Treasury will use in implementing the program.

Among other things this rule addresses:

- Guidance on the Lines of Insurance covered under the act
- Which entities are eligible for participation
- Control and affiliation issues

The Insurance industry generally and many of your representatives specifically have been very helpful in representing your views to the Treasury Department on these and other issues.

However I urge all of you to review these regulations closely to make certain you are in compliance with the act and can take advantage of this important federal protection.

Slide 11:

One of the most discussed issues in the new regulations was the definitions of affiliate and what constitutes control. The issue is important because it goes to the heart of understanding the appropriate deductible to assign various affiliated insurance groups.

Conclusive Control Exists

- if an insurer has power to vote 25% or more of any class of voting securities of the other insurer.
- if an insurer controls the election of a majority of the Directors or Trustees of the other insurer.

Presumptive Control Exists

If the Secretary of the Treasury determines that an insurer exercises a controlling influence over another insurer.

In determining presumptive control The Secretary will consider approximately 11 other factors outlined in the regulations the presence of any 2 could lead to a determination of presumptive control

Hopefully it comes as no surprise to you that in Washington we do read the insurance trade publications. And we have noticed that some industry trade journals have described a number of "gaming" strategies to reduce an insurer's exposure, including mechanisms to thwart the affiliate and control guidelines. Please understand that we will do all that is necessary to maintain the integrity of the program and to prevent the evasion of insurer deductibles under TRIA

Slide 12:

However we do understand that these rules and regulations can be confusing and that honest minds can differ over the meaning, intent, and interpretation of all aspects of the program.

In fact these rules envision that there will be some confusion over many issues including the definition of an insurer and what constitutes a controlling interest.

We continue to receive many questions on these and many other topics. So if after reviewing these regulations in some detail you still have questions you may request an interpretation of the regulations as they apply to your specific situation.

In submitting your request it is not necessary to compose a lengthy dissertation and we will make every effort to respond to your issues in a timely manner

Slide 13:

The ink is not yet dry on there final rules and we are already working to finalize a second set of rules which will address and finalize such issues as:

- Make available requirements
- Disclosure requirements
- State residual markets

Unfortunately this process is really never ending.

Thousands of pages of rules, definitions, procedures, and regulations will be drafted, debated, and finalized over the next 3 years. And believe me there are still many issues to deal with.

Slide 14:

Even though much has been accomplished, considerable work remains. Many in the industry have expressed concerns over such program issues as:

- Adverse selection
- Continued lack of reinsurance availability
- Huge exposures particularly in worker's compensation
- Affordability

In fact most of these issues have been volatile at various and numerous times in the past.

TRIA was passed in part to address them. These issues are in fact characteristic of other past Federal Insurance programs.

I believe that over time the free market will help solve these problems while TRIA contributes over time to help build capacity and stabilize the market. Again this was precisely what the program was designed to do.

Slide 15:

Right now, what keeps me awake at night are operational issues. We have a huge amount of work ahead of us and not very much time to accomplish it.

In addition to having a tremendous amount to accomplish to get our program up and running we have also had to put emergency procedures in place so that should

there be a loss before we are fully operational we will be able to respond to that loss.

In essence this means working on a duel approach to make certain we are prepared.

So as we go about implementing all of issues you see before you and more let me describe the last bullet on the slide in more detail.

Through out my career both in the private sector and with my government service I have been a strong advocate of outsourcing functions that can be better handled by others with more experience and expertise.

I have also where possible created partnerships between the government and private sector insurance industry which draws on the strengths of both entities to create a more successful program. That was why we created the Write Your Own program for the National Flood Insurance Program many years ago.

Therefore it should come as no surprise that in implementing this program we will not be creating a huge infrastructure.

Rather we will establish a virtual company that permits us to form new partnerships with the private insurance sector, harnessing that Insurance Industry's talents and skills to make this an effective streamlined operation.

Slide 16

In addition to the overall operational issues we just discussed we also know there are many specific claims issues to deal with including the speed with which we will be able to reimburse insures all the way down the list to the mechanisms by which we will audit our own payments.

Hopefully it will come as good news to you that we intend that claims made under the program will be processed and paid in a manner highly consistent with what you now experience with the reinsurance industry.

In implementing all of the requirements necessary to pass our own audits, as well as the expected GAO audits, we will be mindful of current insurance industry practices standards and needs.

We will do our best to meet those needs as well as protect the people's assets without overreaching.

Conclusion:

Ladies and gentlemen like all of you I sincerely hope and pray that this program will never be tested. But with your help we can at least try to be prepared should our nation ever again be required to call upon our industry to respond to the needs of our insured's

As in the past I look forward to working with the industry on this new venture and in closing thank you for your time here today as well as for your future support.

Related Documents:

- Slides

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.
August 11, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $15,000 million to refund an estimated $8,000 million of publicly held 4-week Treasury bills maturing August 14, 2003, and to raise new cash of approximately $7,000 million.

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

The Federal Reserve System holds $13,481 million of the Treasury bills maturing on August 14, 2003, in the System Open Markét 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-648

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED AUGUST 14, 2003

August 11, 2003

Offering Amount	$15,000 million
Maximum Award (35% of Offering Amount)	$ 5,250 million
Maximum Recognized Bid at a Single Rate	$ 5,250 million
NLP Reporting Threshold	$ 5,250 million
NLP Exclusion Amount	$12,100 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 NM 9
Auction date	August 12, 2003
Issue date	August 14, 2003
Maturity date	September 11, 2003
Original issue date	March 13, 2003
Currently outstanding	$46,768 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.

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
August 11, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	August 14, 2003
Maturity Date:	November 13, 2003
CUSIP Number:	912795NW7

High Rate: 0.940% Investment Rate 1/: 0.960% Price: 99.762

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 39.32%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 34,566,680	$ 14,158,560
Noncompetitive	1,496,687	1,496,687
FIMA (noncompetitive)	345,050	345,050
SUBTOTAL	36,408,417	16,000,297 2/
Federal Reserve	4,986,304	4,986,304
TOTAL	$ 41,394,721	$ 20,986,601

Median rate 0.925%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.910%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 36,408,417 / 16,000,297 = 2.28

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,201,826,000

JS-649

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
August 11, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	August 14, 2003
Maturity Date:	February 12, 2004
CUSIP Number:	912795PK1

High Rate: 1.030% Investment Rate 1/: 1.053% Price: 99.479

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 31.88%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 25,360,095	$ 14,696,183
Noncompetitive	1,153,873	1,153,873
FIMA (noncompetitive)	150,000	150,000
SUBTOTAL	26,663,968	16,000,056 2/
Federal Reserve	5,530,003	5,530,003
TOTAL	$ 32,193,971	$ 21,530,059

Median rate 1.015%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.000%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 26,663,968 / 16,000,056 = 1.67

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $868,466,000

JS-650

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 12, 2003
2003-8-12-15-6-36-18639

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 $81,085 million as of the end of that week, compared to $80,635 million as of the end of the prior week.

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

		August 1, 2003			August 8, 2003		
	TOTAL		**80,635**			**81,085**	
1. Foreign Currency Reserves [1]		**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities		7,450	13,108	20,558	7,516	13,216	20,732
Of which, issuer headquartered in the U.S.				0			0
b. Total deposits with:							
b.i. Other central banks and BIS		12,193	2,632	14,825	12,273	2,654	14,927
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]				22,625			22,740
3. Special Drawing Rights (SDRs) [2]				11,583			11,643
4. Gold Stock [3]				11,044			11,044
5. Other Reserve Assets				0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	August 1, 2003			August 8, 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-651

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

	August 1, 2003			August 8, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions Headquartered in the U.S.						
3.c. With banks and other financial institutions Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

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

Reserves for the prior week are final.

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

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

FROM THE OFFICE OF PUBLIC AFFAIRS

August 13, 2003
JS-652

Treasury and Federal Reserve Identify Top Five Fundamentals

The Treasury Department and the Federal Reserve Board today announced the top five fundamental practices that consumers should follow to manage their personal credit.

During a May 22, 2003 credit management panel discussion hosted by Treasury and the Federal Reserve and attended by representatives of financial services organizations and community and consumer groups, consensus was reached on the following five fundamental practices:

1. Build savings to avoid high-cost debt and improve payment options.
2. Pay bills on time.
3. Pay more than the minimum payment.
4. Comparison shop for credit and obtain only the credit you need.
5. Understand your credit history and how it affects you.

"These fundamentals are an important first step toward educating all Americans about the importance of responsible credit management," said Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy. "Wise management of personal credit is vitally important to reaching goals such as homeownership, higher education, and small business development."

"Credit must be managed carefully and these concepts offer guidance on how to do so," said Federal Reserve Board Governor Edward M. Gramlich. "The fundamentals of money management can help people make smart decisions that promote their own well-being and, on a broader scale, foster a more efficient economy."

Participants in the May 22 panel discussion, chaired by Assistant Secretary Abernathy and Governor Gramlich, included representatives from the National Foundation for Credit Counseling, the Association for Financial Counseling and Planning Education, the In-Charge Institute, the American Bankers Association, America's Community Bankers, the Credit Union National Association, the Fannie Mae Foundation, Freddie Mac, American Express, MasterCard, Visa, the Community Financial Services Association of America, the Consumer Federation of America, the National Council of La Raza, AARP, and College Parents of America.

The issue of credit management is one of four areas of focus for the Treasury Department's Office of Financial Education (OFE), established in 2002. The OFE works to promote access to financial education programs so that Americans obtain the practical knowledge and skills that will enable them to make informed financial choices throughout their lives. The OFE chairs the Federal Government Financial Education Coordinating Group.

As the agency with responsibility for the Truth in Lending Act regulations, the Federal Reserve has worked to promote access to credit and fair lending for under-served consumers and communities. In 2000, the Federal Reserve hosted a discussion on best practices in consumer credit education; and through its Web site and consumer education materials is working to ensure that consumers know their rights and responsibilities in credit transactions.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 13, 2003
JS-653

Office of Financial Education Announces Online Financial Education Directory

The Treasury Department's Office of Financial Education (OFE) today announced the availability of a new online "Federal Financial Education Resources" directory that will make financial education information more accessible to government entities, community-based organizations, and the general public.

The directory, available at www.treas.gov/financialeducation, provides access to the many resources available within the federal government to assist in the implementation of financial education initiatives. More than twenty-five separate resources are listed, and programs are catalogued by subject area, program name and sponsoring organization.

"Throughout the federal government, agencies are sponsoring and developing financial education initiatives directed to a broad and diverse constituency, and for the first time, this wealth of resources is available in a single location," said Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy. "This directory is a great first step in providing access to financial education for all Americans."

The Office of Financial Education, established in 2002, seeks to ensure that all Americans have access to financial education programs and that they obtain the practical knowledge and skill sets that will enable them to make informed financial choices throughout various life stages.

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.
August 14, 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 $31,043 million of publicly held 13-week and 26-week Treasury bills maturing August 21, 2003, and to raise new cash of approximately $957 million. Also maturing is an estimated $10,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced August 18, 2003.

The Federal Reserve System holds $14,303 million of the Treasury bills maturing on August 21, 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 August 19, 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 $1,046 million into the 13-week bill and $624 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 655

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED AUGUST 21, 2003

		August 14, 2003
Offering Amount	$16,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$ 5,600 million	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 5,600 million	$ 5,600 million
NLP Reporting Threshold	$ 5,600 million	$ 5,600 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 NX 5	912795 PL 9
Auction date	August 18, 2003	August 18, 2003
Issue date	August 21, 2003	August 21, 2003
Maturity date	November 20, 2003	February 19, 2004
Original issue date	May 22, 2003	August 21, 2003
Currently outstanding	$21,931 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

FOR IMMEDIATE RELEASE
August 15, 2003

Contact: Office of Financing
(202) 691-3550

TREASURY'S INFLATION-INDEXED SECURITIES SEPTEMBER 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 September 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 October is expected to be released on September 16, 2003.

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September Reference CPI Numbers and Daily Index Ratios Table PDF format (file size-16KB, uploaded-08/15/03)

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3-3/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2007

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.15946
September	2	2003	183.70667	1.15950
September	3	2003	183.71333	1.15955
September	4	2003	183.72000	1.15959
September	5	2003	183.72667	1.15963
September	6	2003	183.73333	1.15967
September	7	2003	183.74000	1.15971
September	8	2003	183.74667	1.15976
September	9	2003	183.75333	1.15980
September	10	2003	183.76000	1.15984
September	11	2003	183.76667	1.15988
September	12	2003	183.77333	1.15993
September	13	2003	183.78000	1.15997
September	14	2003	183.78667	1.16001
September	15	2003	183.79333	1.16005
September	16	2003	183.80000	1.16009
September	17	2003	183.80667	1.16014
September	18	2003	183.81333	1.16018
September	19	2003	183.82000	1.16022
September	20	2003	183.82667	1.16026
September	21	2003	183.83333	1.16030
September	22	2003	183.84000	1.16035
September	23	2003	183.84667	1.16039
September	24	2003	183.85333	1.16043
September	25	2003	183.86000	1.16047
September	26	2003	183.86667	1.16051
September	27	2003	183.87333	1.16056
September	28	2003	183.88000	1.16060
September	29	2003	183.88667	1.16064
September	30	2003	183.89333	1.16068

3-5/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2008

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.13708
September	2	2003	183.70667	1.13712
September	3	2003	183.71333	1.13716
September	4	2003	183.72000	1.13720
September	5	2003	183.72667	1.13724
September	6	2003	183.73333	1.13728
September	7	2003	183.74000	1.13732
September	8	2003	183.74667	1.13736
September	9	2003	183.75333	1.13741
September	10	2003	183.76000	1.13745
September	11	2003	183.76667	1.13749
September	12	2003	183.77333	1.13753
September	13	2003	183.78000	1.13757
September	14	2003	183.78667	1.13761
September	15	2003	183.79333	1.13765
September	16	2003	183.80000	1.13769
September	17	2003	183.80667	1.13774
September	18	2003	183.81333	1.13778
September	19	2003	183.82000	1.13782
September	20	2003	183.82667	1.13786
September	21	2003	183.83333	1.13790
September	22	2003	183.84000	1.13794
September	23	2003	183.84667	1.13798
September	24	2003	183.85333	1.13802
September	25	2003	183.86000	1.13807
September	26	2003	183.86667	1.13811
September	27	2003	183.87333	1.13815
September	28	2003	183.88000	1.13819
September	29	2003	183.88667	1.13823
September	30	2003	183.89333	1.13827

3-5/8% TREASURY 30-YEAR INFLATION-INDEXED BONDS
Due April 15, 2028

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.13577
September	2	2003	183.70667	1.13581
September	3	2003	183.71333	1.13586
September	4	2003	183.72000	1.13590
September	5	2003	183.72667	1.13594
September	6	2003	183.73333	1.13598
September	7	2003	183.74000	1.13602
September	8	2003	183.74667	1.13606
September	9	2003	183.75333	1.13610
September	10	2003	183.76000	1.13614
September	11	2003	183.76667	1.13619
September	12	2003	183.77333	1.13623
September	13	2003	183.78000	1.13627
September	14	2003	183.78667	1.13631
September	15	2003	183.79333	1.13635
September	16	2003	183.80000	1.13639
September	17	2003	183.80667	1.13643
September	18	2003	183.81333	1.13647
September	19	2003	183.82000	1.13652
September	20	2003	183.82667	1.13656
September	21	2003	183.83333	1.13660
September	22	2003	183.84000	1.13664
September	23	2003	183.84667	1.13668
September	24	2003	183.85333	1.13672
September	25	2003	183.86000	1.13676
September	26	2003	183.86667	1.13680
September	27	2003	183.87333	1.13685
September	28	2003	183.88000	1.13689
September	29	2003	183.88667	1.13693
September	30	2003	183.89333	1.13697

3-7/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2009

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.12012
September	2	2003	183.70667	1.12016
September	3	2003	183.71333	1.12020
September	4	2003	183.72000	1.12024
September	5	2003	183.72667	1.12028
September	6	2003	183.73333	1.12033
September	7	2003	183.74000	1.12037
September	8	2003	183.74667	1.12041
September	9	2003	183.75333	1.12045
September	10	2003	183.76000	1.12049
September	11	2003	183.76667	1.12053
September	12	2003	183.77333	1.12057
September	13	2003	183.78000	1.12061
September	14	2003	183.78667	1.12065
September	15	2003	183.79333	1.12069
September	16	2003	183.80000	1.12073
September	17	2003	183.80667	1.12077
September	18	2003	183.81333	1.12081
September	19	2003	183.82000	1.12085
September	20	2003	183.82667	1.12089
September	21	2003	183.83333	1.12093
September	22	2003	183.84000	1.12098
September	23	2003	183.84667	1.12102
September	24	2003	183.85333	1.12106
September	25	2003	183.86000	1.12110
September	26	2003	183.86667	1.12114
September	27	2003	183.87333	1.12118
September	28	2003	183.88000	1.12122
September	29	2003	183.88667	1.12126
September	30	2003	183.89333	1.12130

3-7/8% TREASURY 30-YEAR INFLATION-INDEXED BONDS
Due April 15, 2029

Ref CPI and Index Ratios for September 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 DATE:	October 15, 1999 October 15, 2000
MATURITY DATE:	April 15, 2029
Ref CPI on DATED DATE:	164.39333
TABLE FOR MONTH OF:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.11744
September	2	2003	183.70667	1.11748
September	3	2003	183.71333	1.11752
September	4	2003	183.72000	1.11756
September	5	2003	183.72667	1.11760
September	6	2003	183.73333	1.11764
September	7	2003	183.74000	1.11769
September	8	2003	183.74667	1.11773
September	9	2003	183.75333	1.11777
September	10	2003	183.76000	1.11781
September	11	2003	183.76667	1.11785
September	12	2003	183.77333	1.11789
September	13	2003	183.78000	1.11793
September	14	2003	183.78667	1.11797
September	15	2003	183.79333	1.11801
September	16	2003	183.80000	1.11805
September	17	2003	183.80667	1.11809
September	18	2003	183.81333	1.11813
September	19	2003	183.82000	1.11817
September	20	2003	183.82667	1.11821
September	21	2003	183.83333	1.11825
September	22	2003	183.84000	1.11829
September	23	2003	183.84667	1.11833
September	24	2003	183.85333	1.11837
September	25	2003	183.86000	1.11842
September	26	2003	183.86667	1.11846
September	27	2003	183.87333	1.11850
September	28	2003	183.88000	1.11854
September	29	2003	183.88667	1.11858
September	30	2003	183.89333	1.11862

4-1/4% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2010

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.09186
September	2	2003	183.70667	1.09190
September	3	2003	183.71333	1.09194
September	4	2003	183.72000	1.09198
September	5	2003	183.72667	1.09202
September	6	2003	183.73333	1.09206
September	7	2003	183.74000	1.09210
September	8	2003	183.74667	1.09214
September	9	2003	183.75333	1.09218
September	10	2003	183.76000	1.09222
September	11	2003	183.76667	1.09226
September	12	2003	183.77333	1.09229
September	13	2003	183.78000	1.09233
September	14	2003	183.78667	1.09237
September	15	2003	183.79333	1.09241
September	16	2003	183.80000	1.09245
September	17	2003	183.80667	1.09249
September	18	2003	183.81333	1.09253
September	19	2003	183.82000	1.09257
September	20	2003	183.82667	1.09261
September	21	2003	183.83333	1.09265
September	22	2003	183.84000	1.09269
September	23	2003	183.84667	1.09273
September	24	2003	183.85333	1.09277
September	25	2003	183.86000	1.09281
September	26	2003	183.86667	1.09285
September	27	2003	183.87333	1.09289
September	28	2003	183.88000	1.09293
September	29	2003	183.88667	1.09297
September	30	2003	183.89333	1.09301

3-1/2% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2011

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.05547
September	2	2003	183.70667	1.05551
September	3	2003	183.71333	1.05555
September	4	2003	183.72000	1.05559
September	5	2003	183.72667	1.05563
September	6	2003	183.73333	1.05566
September	7	2003	183.74000	1.05570
September	8	2003	183.74667	1.05574
September	9	2003	183.75333	1.05578
September	10	2003	183.76000	1.05582
September	11	2003	183.76667	1.05586
September	12	2003	183.77333	1.05589
September	13	2003	183.78000	1.05593
September	14	2003	183.78667	1.05597
September	15	2003	183.79333	1.05601
September	16	2003	183.80000	1.05605
September	17	2003	183.80667	1.05609
September	18	2003	183.81333	1.05612
September	19	2003	183.82000	1.05616
September	20	2003	183.82667	1.05620
September	21	2003	183.83333	1.05624
September	22	2003	183.84000	1.05628
September	23	2003	183.84667	1.05632
September	24	2003	183.85333	1.05635
September	25	2003	183.86000	1.05639
September	26	2003	183.86667	1.05643
September	27	2003	183.87333	1.05647
September	28	2003	183.88000	1.05651
September	29	2003	183.88667	1.05655
September	30	2003	183.89333	1.05658

3-3/8% TREASURY 30-1/2-YEAR INFLATION-INDEXED BONDS Due April 15, 2032

Ref CPI and Index Ratios for September 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
MATURITY DATE:	April 15, 2032
Ref CPI on DATED DATE:	177.50000
TABLE FOR MONTH OF:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.03493
September	2	2003	183.70667	1.03497
September	3	2003	183.71333	1.03500
September	4	2003	183.72000	1.03504
September	5	2003	183.72667	1.03508
September	6	2003	183.73333	1.03512
September	7	2003	183.74000	1.03515
September	8	2003	183.74667	1.03519
September	9	2003	183.75333	1.03523
September	10	2003	183.76000	1.03527
September	11	2003	183.76667	1.03531
September	12	2003	183.77333	1.03534
September	13	2003	183.78000	1.03538
September	14	2003	183.78667	1.03542
September	15	2003	183.79333	1.03546
September	16	2003	183.80000	1.03549
September	17	2003	183.80667	1.03553
September	18	2003	183.81333	1.03557
September	19	2003	183.82000	1.03561
September	20	2003	183.82667	1.03564
September	21	2003	183.83333	1.03568
September	22	2003	183.84000	1.03572
September	23	2003	183.84667	1.03576
September	24	2003	183.85333	1.03579
September	25	2003	183.86000	1.03583
September	26	2003	183.86667	1.03587
September	27	2003	183.87333	1.03591
September	28	2003	183.88000	1.03594
September	29	2003	183.88667	1.03598
September	30	2003	183.89333	1.03602

3-3/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due January 15, 2012

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.03455
September	2	2003	183.70667	1.03459
September	3	2003	183.71333	1.03463
September	4	2003	183.72000	1.03467
September	5	2003	183.72667	1.03470
September	6	2003	183.73333	1.03474
September	7	2003	183.74000	1.03478
September	8	2003	183.74667	1.03482
September	9	2003	183.75333	1.03485
September	10	2003	183.76000	1.03489
September	11	2003	183.76667	1.03493
September	12	2003	183.77333	1.03497
September	13	2003	183.78000	1.03500
September	14	2003	183.78667	1.03504
September	15	2003	183.79333	1.03508
September	16	2003	183.80000	1.03512
September	17	2003	183.80667	1.03515
September	18	2003	183.81333	1.03519
September	19	2003	183.82000	1.03523
September	20	2003	183.82667	1.03527
September	21	2003	183.83333	1.03530
September	22	2003	183.84000	1.03534
September	23	2003	183.84667	1.03538
September	24	2003	183.85333	1.03542
September	25	2003	183.86000	1.03545
September	26	2003	183.86667	1.03549
September	27	2003	183.87333	1.03553
September	28	2003	183.88000	1.03557
September	29	2003	183.88667	1.03560
September	30	2003	183.89333	1.03564

3% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due July 15, 2012

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.02169
September	2	2003	183.70667	1.02173
September	3	2003	183.71333	1.02176
September	4	2003	183.72000	1.02180
September	5	2003	183.72667	1.02184
September	6	2003	183.73333	1.02188
September	7	2003	183.74000	1.02191
September	8	2003	183.74667	1.02195
September	9	2003	183.75333	1.02199
September	10	2003	183.76000	1.02202
September	11	2003	183.76667	1.02206
September	12	2003	183.77333	1.02210
September	13	2003	183.78000	1.02214
September	14	2003	183.78667	1.02217
September	15	2003	183.79333	1.02221
September	16	2003	183.80000	1.02225
September	17	2003	183.80667	1.02228
September	18	2003	183.81333	1.02232
September	19	2003	183.82000	1.02236
September	20	2003	183.82667	1.02240
September	21	2003	183.83333	1.02243
September	22	2003	183.84000	1.02247
September	23	2003	183.84667	1.02251
September	24	2003	183.85333	1.02254
September	25	2003	183.86000	1.02258
September	26	2003	183.86667	1.02262
September	27	2003	183.87333	1.02265
September	28	2003	183.88000	1.02269
September	29	2003	183.88667	1.02273
September	30	2003	183.89333	1.02277

1-7/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due July 15, 2013

Ref CPI and Index Ratios for September 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:	September 2003
NUMBER OF DAYS IN MONTH:	30
CPI-U (NSA) May 2003	183.5
CPI-U (NSA) June 2003	183.7
CPI-U (NSA) July 2003	183.9

Month	Calendar Day	Year	Ref CPI	Index Ratio
September	1	2003	183.70000	1.00019
September	2	2003	183.70667	1.00023
September	3	2003	183.71333	1.00027
September	4	2003	183.72000	1.00030
September	5	2003	183.72667	1.00034
September	6	2003	183.73333	1.00037
September	7	2003	183.74000	1.00041
September	8	2003	183.74667	1.00045
September	9	2003	183.75333	1.00048
September	10	2003	183.76000	1.00052
September	11	2003	183.76667	1.00056
September	12	2003	183.77333	1.00059
September	13	2003	183.78000	1.00063
September	14	2003	183.78667	1.00067
September	15	2003	183.79333	1.00070
September	16	2003	183.80000	1.00074
September	17	2003	183.80667	1.00077
September	18	2003	183.81333	1.00081
September	19	2003	183.82000	1.00085
September	20	2003	183.82667	1.00088
September	21	2003	183.83333	1.00092
September	22	2003	183.84000	1.00096
September	23	2003	183.84667	1.00099
September	24	2003	183.85333	1.00103
September	25	2003	183.86000	1.00106
September	26	2003	183.86667	1.00110
September	27	2003	183.87333	1.00114
September	28	2003	183.88000	1.00117
September	29	2003	183.88667	1.00121
September	30	2003	183.89333	1.00125

FROM THE OFFICE OF PUBLIC AFFAIRS

August 15, 2003
JS-659

LOCAL TV Board Proposes Rule to Bring Local TV to Nonserved and Underserved Areas

The LOCAL Television Loan Guarantee Board today issued a proposed regulation to implement the LOCAL Television Loan Guarantee Program, as authorized by the Launching Our Communities' Access to Local Television Act of 2000. The proposed rule appeared in the Federal Register today.

The proposed rule establishes the Program's eligibility and guarantee requirements, the application and approval process, as well as the administration of guarantees made by the Board. Additionally, the rule proposes the process through which the Board will consider applications under the priority considerations required in the Act.

The Act established the LOCAL Television Loan Guarantee Board and authorized it to guarantee up to 80% of loans totaling no more than $1.25 billion to facilitate access, on a technologically neutral basis, to signals of local television stations for households located in nonserved areas and underserved areas.

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

Written comments on the proposed rule must be received by the LOCAL Television Loan Guarantee Board, or bear a postmark or equivalent, no later than September 15, 2003. Comments regarding the information and recordkeeping requirements must be received by October 14, 2003.
Written comments should be addressed to Secretary, LOCAL Television Loan Guarantee Board, STOP 1575, Room 2919-S, 1400 Independence Avenue, SW, Washington, DC 20250-1575. Telephone (202) 720-0530; Facsimile (202) 720-2734; E-mail localtv@rus.usda.gov.

The full text of the rule and additional information about the Program are available on its website at: http://www.usda.gov/rus/localtvboard/.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 15, 2003
JS-660

Statement by Treasury Assistant Secretary for Public Affairs Rob Nichols

We applaud the initial response of the financial services industry, including the exchanges and their member firms, to the power outage. The extraordinary commitment of the men and women who make our markets work have again demonstrated the resiliency and strength of the U.S. financial system. The fact that the markets have operated so smoothly under these adverse conditions and have continued functioning in relatively normal fashion, underscores the confidence people around the world have in the U.S. financial markets.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 14, 2003
JS-662

Statement by Treasury Spokesman Rob Nichols
in response to the power outage affecting the U.S. and Canada

The U.S. financial system is extremely resilient. Power went down after the stock markets were closed. Our information is that market participants and exchanges were able to shut down in an orderly manner. We are actively monitoring the situation and are in close touch with the financial regulators, the bond markets, the New York Fed and others.The bond markets are not disrupted. We have not received reports of any major disruption to the nation's banking system.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 15, 2003
JS-664

Designation of National Council of Resistance in Iran, National Council of Resistance and Peoples Mujahedin of Iran under Executive Order 13224

In support of a State Department amendment to the designation of Mujahedin-e Khalq (MEK), the Treasury Department's Office of Foreign Assets Control (OFAC) has listed the National Council of Resistance in Iran (NCRI) -- previously listed as a Foreign Terrorist Organization (FTO) -- as a Specially Designated Global Terrorist (SDGT) under Executive Order 13224 and has clarified that the National Council of Resistance (NCR) and People's Mujahedin of Iran (PMOI) are aliases of MEK. The listing also clarifies that the designation includes the U.S. representative offices of NCRI and the U.S. press office of PMOI. These organizations have been added to the Specially Designated Nationals (SDN) list, effectively freezing all assets and properties and prohibiting transactions between U.S. persons and these organizations.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 15, 2003
JS-665

Treasury Department Praises Financial Markets for Response to Power Outage and Announces Filing Relief for Taxpayers in Affected Area

Treasury Secretary John Snow today praised the financial institutions and the men and women who make U.S. financial markets work for their initial response to yesterday's massive power outage. He also announced that the IRS will grant a one-week extension for taxpayers in the affected area to file their returns.

"We applaud the initial response of critical financial institutions to the power outage," said Secretary Snow. "The men and women who make our markets work did an extraordinary job of ensuring that our financial markets lived up to their reputation as the most resilient in the world."

Despite the power outage that caused disruptions in large parts of the United States and Canada, the U.S. financial system weathered the outage relatively well.

Even though outage began at about 4:11 pm EDT after the stock markets were closed, financial firms still had a considerable volume of after-market trades to process. But due to back-up systems, critical financial institutions were able to handle these functions.

The Treasury Department has received no reports of any major disruptions to the financial system, no reports of major damage to financial systems, and no reports of losses of financial data.

The nation's financial system was largely unaffected by the outage due in particular to the steps the private sector has taken to enhance the resiliency of their systems.

Enhancements to the nation's financial infrastructure include:

• People. The men and women who make the financial system work have again shown great professionalism in a time of challenge. They have again shown great commitment to the safety of their colleagues, the health of their institutions, and the well-being of their customers. Many of these professionals have participated in numerous drills, simulations, and tests since September 11, 2001. Even when these exercises did not involve a response to a power outage, they helped further prepare the people who make the system work.

• Procedures. After September 11, 2001, many institutions revised and improved their business continuity procedures. These new procedures appear to have helped the financial system weather the outage. Regular testing of systems and plans, combined with cross training of key employees, helped to ensure continuity of operations. For example, certain financial institutions implemented procedures to redirect operations to back-up facilities in areas not affected by the outage.

• Systems. Many institutions have invested in new or upgraded business continuity equipment, including un-interruptible power supply systems and back-up generators. This enabled a number of institutions to seamlessly switch their information technology operations to back-up power sources, preserving the

integrity of data and continuing the orderly processing of transactions.

• Communication. Financial institutions did an excellent job of communicating their status to their employees, customers, and counter-parties. In particular, market participants are to be commended for their early commitment to open for business today despite the outage. In addition, the Financial Services Sector Coordinating Council did a superb job of sharing information within the industry and between the industry and the financial regulators.

• Cooperation. The financial regulators worked together to share information and solve problems. Shortly after the outage, the Financial and Banking Information Infrastructure Committee (FBIIC), which is chaired by the Treasury and comprised of federal and state financial regulators, convened a conference call to discuss the impact of the outage on the financial sector. There also was good cooperation between financial regulators and state and local authorities.

The Department recognizes that while we are still in the process of restoring power and returning operations of utilities, transportation services, and the financial industry to normal, we are confident that the industry will continue to meet this challenge with the same success with which they have initially responded to the outage.

While the financial infrastructure and the markets are largely unaffected by the outage, individual taxpayers in the area have been affected. As a result, the Treasury Department today is announcing that it is granting additional time for taxpayers to file returns.

The Internal Revenue Service will offer relief for those hit by the power blackout in the Northeastern United States. The IRS will consider as timely any tax returns or payments due from today through Friday, Aug. 22, 2003 if they are completed by Aug. 22, 2003.

"The IRS is doing the right thing for taxpayers by providing this important relief to those affected by the power outages in the Northeast," Secretary Snow said.

Interest will continue on any overdue taxes during this period, but penalties will be waived. To qualify for this relief, affected taxpayers should put "NORTHEAST BLACKOUT" in red ink at the top of the return relying on this relief.

"We want to make sure that taxpayers affected by the blackout don't have to worry about today's filing deadline; it's the least we can do," said Secretary Snow.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 15, 2003
JS-666

Treasury Announces Decision on Group Life Coverage Under Terrorism Risk Insurance Program

The Treasury Department today announced its decision on group life insurance coverage under the Terrorism Risk Insurance Program. As passed by Congress, the Terrorism Risk Insurance Act of 2002 did not provide coverage for group life insurance policies. Instead, the Treasury Department was tasked with evaluating market conditions and making a determination on coverage. Treasury could include coverage for group life insurance if both insurance and reinsurance were not available, or not likely to be available in the future.

During its evaluation, the Treasury found no appreciable reduction in the availability of group life insurance coverage for consumers, although Treasury did find a current general lack of catastrophic reinsurance for insurance companies that offer group life coverage. Given that evaluation, Treasury has determined that it could not extend taxpayer coverage for group life insurance under the Terrorism Risk Insurance Program.

"This decision is the result of a careful consideration of market conditions, with significant input from users and providers of group life insurance," said Assistant Treasury Secretary for Financial Institutions Wayne A. Abernathy. "We were pleased to find that group life insurance companies have stayed with their customers and continued to make group life insurance available on much the same terms as before the terrorist tragedies of September 11th. However, Treasury will continue to monitor conditions and developments in the market for group life insurance."

The Terrorism Risk Insurance Act of 2002 was enacted to provide a temporary federal reinsurance backstop for providers of commercial property and casualty insurance against risks from international terrorism while the private sector develops its own resources and programs. Such resources and programs would include traditional reinsurance, as well as other market mechanisms for risk sharing. The coverage under the legislation expires on December 31, 2005.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 18, 2003
2003-8-18-17-18-48-28990

Air Transportation Stabilization Board Announces Resignation of Executive Director Daniel G. Montgomery

The Air Transportation Stabilization Board (ATSB) today announced the resignation of Daniel G. Montgomery as Executive Director, effective August 22, 2003. Mr. Montgomery, named Executive Director in April 2002, has accepted a position with Kroll Zolfo Cooper LLC, the financial consulting subsidiary of Kroll Inc.

ATSB Chairman Edward M. Gramlich said, "I want to express the Board's gratitude to Dan Montgomery for his service to the ATSB. Dan has extensive knowledge of capital markets and has used it well, working tirelessly during a period critical to the nation's airline industry."

Until a new Executive Director is named, Treasury Assistant Secretary for Financial Markets Brian C. Roseboro will serve as Acting Executive Director of the ATSB.

Additional information on the ATSB is available on its web site, www.treas.gov/atsb.

-30-

JS 667

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
August 18, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	August 21, 2003
Maturity Date:	November 20, 2003
CUSIP Number:	912795NX5

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 53.97%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 29,669,628	$ 14,370,686
Noncompetitive	1,389,452	1,389,452
FIMA (noncompetitive)	240,000	240,000
SUBTOTAL	31,299,080	16,000,138 2/
Federal Reserve	5,475,804	5,475,804
TOTAL	$ 36,774,884	$ 21,475,942

Median rate 0.940%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.920%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 31,299,080 / 16,000,138 = 1.96

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,135,174,000

JS 668

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
August 18, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	August 21, 2003
Maturity Date:	February 19, 2004
CUSIP Number:	912795PL9

High Rate: 1.035% Investment Rate 1/: 1.057% Price: 99.477

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 7.82%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 28,500,415	$ 14,834,080
Noncompetitive	916,325	916,325
FIMA (noncompetitive)	250,000	250,000
SUBTOTAL	29,666,740	16,000,405 2/
Federal Reserve	5,720,975	5,720,975
TOTAL	$ 35,387,715	$ 21,721,380

Median rate 1.020%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.000%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 29,666,740 / 16,000,405 = 1.85

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $687,061,000

JS-669

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.
August 18, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $18,000 million to refund an estimated $10,000 million of publicly held 4-week Treasury bills maturing August 21, 2003, and to raise new cash of approximately $8,000 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 $14,303 million of the Treasury bills maturing on August 21, 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 670

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED AUGUST 21, 2003

August 18, 2003

Offering Amount	$18,000 million
Maximum Award (35% of Offering Amount)	$ 6,300 million
Maximum Recognized Bid at a Single Rate	$ 6,300 million
NLP Reporting Threshold	$ 6,300 million
NLP Exclusion Amount	$12,000 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 NN 7
Auction date	August 19, 2003
Issue date	August 21, 2003
Maturity date	September 18, 2003
Original issue date	March 20, 2003
Currently outstanding	$46,634 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 18, 2003
JS-671

Secretary Snow to Encourage Economic Growth in Asia

Treasury Secretary John Snow will travel to three Asian nations in early September where he will encourage countries to take strong measures to increase global economic growth.

Secretary Snow will visit Tokyo, Japan September 1-2; Beijing, China September 2-3; and then Phuket, Thailand on September 4-5 for meetings with finance ministers of the Asia-Pacific Economic Cooperation (APEC) forum.

"Achieving strong and vibrant global growth is one of the world's most pressing priorities," said Secretary Snow. "We live in an interdependent world economy where our fortunes are inextricably linked. Let me be clear: increased economic growth overseas equals more jobs here."

In Japan, Secretary Snow will meet with top political, economic and finance officials of the Government of Japan. He will also meet with private sector economists and financial analysts. Secretary Snow has emphasized the importance of Japan, the world's second largest economy, returning to strong economic growth. Snow will assess Japan's prospects for sustaining economic growth and review the nation's efforts to end deflation and resolve non-performing loans in the nation's banking system.

"Japan's growth is critical not only for its own citizens and for Asia, but also for Americans," said Snow. "Our economy directly benefits when Japan buys more of our goods and that creates jobs for Americans."

Secretary Snow will then travel to Beijing to meet with the Chinese leadership and their top economic officials as well as representatives from the business community and private economists. Secretary Snow will discuss a broad range of issues important to the country's economic relationship with the United States, including liberalization and reform of the financial sector, trade, and exchange rate issues.

The visit to Thailand at the occasion of the meeting of the APEC finance ministers will give Secretary Snow the opportunity to engage in discussions with his counterparts in the region on economic issues affecting the global economy, with particular attention to Asia and the Pacific Rim. In addition to official APEC meetings, Secretary Snow will host a series of bilateral discussions with finance ministers from the region.

Among the issues on the table at the APEC meeting is the plight of the emerging world. Helping emerging nations lift themselves from poverty is a key priority for President Bush and his Administration. Secretary Snow noted that raising growth also aides our friends in emerging economies, "Cooperation between the United States and our trading partners in Asia is vital for raising economic growth and improving living standards -- not just in our regions, but also in the emerging and developing economies as well."

Secretary Snow recently visited the United Kingdom and Germany where he reviewed efforts to generate economic growth in the European Community market. Upon completion of this trip, Secretary Snow – in only seven months on the job -

will have visited the world's largest economies as part of his campaign to encourage global growth.

FROM THE OFFICE OF PUBLIC AFFAIRS

August 22, 2003
JS-672

U.S. Designates Five Charities Funding Hamas and Six Senior Hamas Leaders as Terrorist Entities

Present Bush today announced that the U.S. Treasury is designating five Hamas related charities and six senior Hamas leaders as Specially Designated Global Terrorists (SDGTs), freezing any assets in the U.S. and prohibiting transactions with U.S. nationals. "By claiming responsibility for the despicable act of terror on August 19, Hamas has reaffirmed that it is a terrorist organization committed to violence against Israelis and to undermining progress toward peace between Israel and the Palestinian people," President Bush stated.

"Hamas' leaders and those who provide their funding again have the blood of innocents on their hands," U.S. Treasury Secretary John Snow stated. "Empty words cannot wash them clean. As they resist the road map for peace, Hamas is devastating the dreams of the Palestinian people for freedom, prosperity, and an independent state."

The United States will continue to work with our allies to encourage the recognition of Hamas as a terrorist organization and to shut down their sources of funding and support.

The following individuals are designated as SDGTs by today's action:

1. **Sheik Ahmed Yassin**, the leader of Hamas in Gaza.
2. **Imad Khalil Al-Alami**, a member of the Hamas Political Bureau in Damascus, Syria.
3. **Usama Hamdan**, a senior Hamas leader in Lebanon.
4. **Khalid Mishaal**, head of the Hamas Political Bureau and Executive Committee in Damascus, Syria.
5. **Musa Abu Marzouk**, Deputy Chief of the Political Bureau in Syria.
6. **Abdel Aziz Rantisi,** a Hamas leader in Gaza reporting to Sheik Yassin.

The following charities that provide support to Hamas and form part of its funding network in Europe are designated as well:

1. **Commite de Bienfaisance et de Secours aux Palestiniens (CBSP),** of France.
2. **The Association de Secours Palestinien (ASP),** of Switzerland. (An organization related to CBSP)
3. **The Palestinian Relief and Development Fund, or Interpal,** headquartered in the United Kingdom.
4. **The Palestinian Association in Austria,** PVOE.
5. **The Sanabil Association for Relief and Development,** based in Lebanon.

Today's action follows several actions taken against Hamas previously, including the designation of several entities that formed part of the Hamas network such as Holy Land Foundation for Relief and Development and the Al Aqsa Foundation, key sources of financial support for Hamas.

ATTACHED: Fact Sheet

****END****

Fact Sheet

HAMAS

HAMAS is a terrorist organization that has intentionally killed hundreds of innocent civilians and continues to kill and maim with the aim of terrorizing a civilian population. HAMAS was formed in 1987 as an outgrowth of the Palestinian branch of the Muslim Brotherhood. HAMAS activists have conducted many attacks – including large-scale suicide bombings – against Israeli citizens and military targets. In the early 1990s, they also targeted U.S. citizens, suspected Palestinian collaborators and Fatah rivals.

During 2002, more than 370 persons – including 10 US citizens – were killed in Israel, the West Bank and the Gaza Strip by acts of terrorism. HAMAS was responsible for carrying out more than 50 of these attacks, including shootings, suicide bombings, and standoff mortar-and-rocket attacks against civilian and military targets. The group was responsible for the most deadly Palestinian terrorist attack of the year – the suicide bombings of a Passover gathering at a Netanya hotel that killed 29 Israelis, including one dual US-Israeli citizen. HAMAS's bombing of a cafeteria on the Hebrew University campus, which killed nine, including five US citizens, demonstrated its willingness to stage operations in areas frequented by students and tourists, including US citizens.

In addition, HAMAS's rejectionist policies and terrorist actions are aimed at derailing the peace process in the Middle East. On April 30, 2003, the U.S. government released the roadmap for peace between Israel and the Palestinians, which constitutes a crucial step in international efforts to actively support movement towards peace in the region. HAMAS, however, has since the mid-90s purposefully worked against all regional peace efforts by engaging in suicide attacks and other acts of the most violent type of terrorism. On June 8 and June 11 HAMAS took credit for attacks against Israelis. The organization also took credit for four suicide bombings in a 24-hour period during the weekend preceding May 20th.

On June 29th, HAMAS and two other designated terrorist groups announced a cease-fire. On August 19th, a suicide bomber detonated his bomb in the back of a double-length city bus near the border between east and west Jerusalem. According to a CNN report, HAMAS said that it was committed to the cease-fire, but also claimed responsibility, stating that "the man was a member of its military wing, the Izzedine al-Qassam Brigades, and the attack came in revenge for the killing of two of its members." As noted by the Human Rights Watch, "the Hamas leadership has pursued attacks against civilians as a conscious policy. A group that pursues multiple, intentional attacks against civilians as a matter of policy is responsible for crimes against humanity." *Erased in a Moment: Suicide Bombing Attacks Against Israeli Civilians* at 67 (October 2002).

Under Executive Order 13224, the United States government may block the assets of HAMAS (which it has done) and the assets of individuals and entities owned or controlled by; acting for or on behalf of; or providing support, financial or otherwise, to designated terrorists and terrorist organizations. HAMAS has been designated as a Foreign Terrorist Organization (66 Fed. Reg. 51088) and as a Specially Designated Global Terrorist (SDGT) under Executive Order 13224, "Blocking Property and Prohibiting Transactions with Persons who Commit, or Support Terrorism."

The United States government has credible evidence that the following six HAMAS leaders that command and control terrorist activity.

Sheik Ahmed YASSIN

Yassin is the head of HAMAS in Gaza. He maintains a direct line of communication with other HAMAS leaders on coordination of HAMAS's military activities and openly admits that there is no distinguishing the political and military wings of Hamas. Yassin also conveys messages about operational planning to other Palestinian terrorist organizations.

Surrounding Yassin is an entourage of personal "bodyguards," including many implicated in providing information and supplies to fugitives, recruiting personnel to undertake military operations, planning terrorist cells, attacking settlements, and manufacturing weapons and explosives.

Imad Khalil AL-ALAMI

Imad al-Alami is a member of HAMAS's Political Bureau, located in Damascus, Syria and a military operations leader. As part of HAMAS's external leadership, he is part of the most effective and powerful wing of HAMAS because it controls the West Bank and prison branches of HAMAS and has gained total financial control.

Al-Alami has had oversight responsibility for the military wing of HAMAS within the Palestinian territories. As a HAMAS military leader, al-Alami directs sending personnel and funding to the West Bank and Gaza.

Usama HAMDAN

Hamdan, a senior HAMAS official based in Lebanon, maintains contact with representatives with other terrorist organizations with the purpose of strengthening the ties between these organizations in order to strengthen an international Islamic Jihad. He has worked with other HAMAS and Hizballah leaders on initiatives to develop and activate the military network inside the Palestinian territories in support of the current intifada, including the movement of weapons, explosives and personnel to the West Bank and Gaza for HAMAS fighters.

Funds transferred from charitable donations to HAMAS for distribution to the families of Palestinian "martyrs" have been transferred to the bank account of Hamdan and used to support HAMAS military operations in Israel.

Mishaal has been responsible for supervising assassination operations, bombings and the killing of Israeli settlers. To execute HAMAS military activities, Mishaal maintains a direct link to Gaza-based HAMAS leader, Abdel Aziz Rantisi *(see* below). He also provides instructions to other parts of the HAMAS military wing.

Funds transferred from charitable donations to HAMAS for distribution to the families of Palestinian martyrs have been transferred to the bank account of Mishaal and used to support HAMAS military operations in Israel.

Musa Abu MARZOUK

Musa Abu Marzouk is the Deputy Chief of HAMAS's Political Bureau based in Damascus, Syria. His activities include directing and coordinating terrorist acts by HAMAS against soldiers and civilians in Israel and the West Bank and Gaza. Marzouk maintains relationships with other terrorist organizations.

The Holy Land Foundation for Relief and Development, designated as an SDGT under EO 13224 in December 2001 based on its support of HAMAS, received start-up funding and instructions from Marzouk. Marzouk is implicated in receiving financing for HAMAS terrorist attacks, funds that have been used to mobilize military activity inside Israel and the West Bank/Gaza.

Abdel Aziz RANTISI

Rantisi is part of the HAMAS leadership in Gaza, operating directly under HAMAS Leader Shaykh Yassin *(see* above) with whom he maintains a direct line of communication for the coordination of military operations. Mishaal *(see* above) has also issued orders for HAMAS terrorist activities through Rantisi.

In October of 2002, Rantisi was reported in Al-Hayat as personally claiming responsibility for the assassination of a Palestinian Authority Police Colonel. In December 2002, he was calling for Iraq to prepare thousands of martyrdom cells to fight the United States and its allies in the event of war.

HAMAS Fundraising

HAMAS raises tens of millions or dollars per year throughout the world using charitable fundraising as cover. While HAMAS may provide money for legitimate charitable work, this work is a primary recruiting tool for the organization's militant causes. HAMAS relies on donations from Palestinian expatriates around the world and private benefactors located in moderate Arab states, Western Europe and North America. HAMAS uses a web of charities to facilitate funding and to funnel money. Charitable donations to non-governmental organizations are commingled, moved between charities in ways that hide the money trail, and then often diverted or siphoned to support terrorism.

The funds pouring into HAMAS coffers directly undermine the Middle East peace process. These funds allow the group to continue to foment violence, strengthen its terrorist infrastructure, and undermine responsible leadership.

The political leadership of HAMAS directs its terrorist networks just as they oversee their other activities. HAMAS leader Yassin confirms this relationship, stating to al-Sharq al-Awsat on August 12, 2002: "When we make decisions on the political level and convey them to the military wing, it abides by it normally." The intensity of this relationship is reflected in Yassin's words quoted by Reuters on May 12, 1998:

We can not separate the wing from the body. If we do so, the body will not be able to fly. HAMAS is one body.

A report issued by Human Rights Watch has also noted the unified nature of HAMAS:

In the case of Hamas, there is abundant evidence that the military wing is accountable to a political steering committee . . . . Yassin himself, as well as Salah Shehadah, the late founder and commander of the 'Izz al-Din al-Qassam Brigades, have confirmed in public remarks that the military wing implements policies that are set by the political wing." *Erased in a Moment: Suicide Bombing Attacks Against Israeli Civilians* at 63 (October 2002).

Fundraising may involve community solicitation in the United States, Canada, Europe and the Middle East or solicitations directly to wealthy donors. While some donors may be aware of the intended use of their donations, too many innocent donors who intend for their money to be used to provide humanitarian services here or abroad, are unwittingly funding acts of violence when these funds are diverted to terrorist causes.

HAMAS fundraising directly undermines Prime Minister Mahmud Abbas's ability to clamp down on this terrorist organization. One of the obstacles and threats to establishing a meaningful dialogue toward peace comes from terrorist groups such as HAMAS, which view peace discussions as inimical to their interests and are intent on undermining the multilateral work on the roadmap by fomenting violence. In order to support momentum towards peace, to strengthen the ability of the new Palestinian leadership to take the actions it must take against HAMAS, the assets of groups like HAMAS must be frozen, as well as the assets of organizations raising funds for such terrorist groups.

E.O. 13224 provides a means to disrupt the financial-support network funding

terrorist attacks committed by HAMAS. Under this Order, the United States government may block the assets of HAMAS (which it has done) and the assets of individuals and entities owned or controlled by; acting for or on behalf of; or providing support, financial or otherwise, to designated terrorists and terrorist organizations. HAMAS has been designated as a Foreign Terrorist Organization (66 Fed. Reg. 51088) and as a Specially Designated Global Terrorist (SDGT) under Executive Order 13224, "Blocking Property and Prohibiting Transactions with Persons who Commit, or Support Terrorism."

The United States government has credible evidence that the following five organizations are part of a web of charities raising funds on behalf of HAMAS and using humanitarians purposes as a cover for acts that support HAMAS. Funds are generated by, and flow through, these organizations on behalf of HAMAS.

Commite de Bienfaisance et de Secours aux Palestiniens (CBSP) and Association de Secours Palestinien (ASP)

CBSP and ASP are primary fundraisers for HAMAS in France and Switzerland, respectively. Founded in France in the late 80s/early 90s, CBSP acts in collaboration with more than a dozen humanitarian organizations based in different towns in the West Bank and Gaza and in Palestinian refugee camps in Jordan and Lebanon. ASP, a subsidiary of CBSP, was founded in Switzerland in 1994. The group has collected large amounts of money from mosques and Islamic centers, which it then transfers to sub-organizations of HAMAS. Khalid Al-Shuli is the president of CBSP and ASP .

Palestinian Relief and Development Fund (Interpal)

Interpal, headquartered in the UK, has been a principal charity utilized to hide the flow of money to HAMAS. Reporting indicates it is the conduit through which money flows to HAMAS from other charities, *e.g.,* the Al Aqsa Foundation (designated under EO 13224 on May 29th) and oversees the activities of other charities. For example, the Sanabil Association for Relief and Development (designated as part of this tranche), represents Interpal in Lebanon. Reporting indicates that Interpal is the fundraising coordinator of HAMAS. This role is of the type that includes supervising activities of charities, developing new charities in targeted areas, instructing how funds should be transferred from one charity to another, and even determining public relations policy.

Sanabil Association for Relief and Development

The Sanabil Association for Relief and Development (Sanabil), based in Sidon, Lebanon, receives large quantities of funds raised by major HAMAS-affiliated charities in Europe and the Middle East and, in turn, provides funding to HAMAS. For example, Sanabil has received funding from the Al Aqsa Foundation (designated as an SDGT under EO 13224 in May 2003); the Holy Land Foundation for Relief and Development (designated as an SDGT under EO 13224 in December 2001), and Interpal (designated as an SDGT under EO 13224 as part of this tranche). HAMAS recruits permanent members from the religious and the poor by extending charity to them from organizations such as Sanabil.

At the request of a HAMAS political leader, Sanabil began opening offices in all of the Palestinian refugee camps in Lebanon in August of 2001 in order to increase the foundation's role inside the camps. After starting by providing basic necessities the charity eventually began asking poor families within the camps to fill out application forms, particularly those who had worked with the Islamic Movement (Al-Haraka al-Islamiyya) and HAMAS. As a result of these efforts, Sanabil has increased its scope of influence within the camps.

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
August 19, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	August 21, 2003
Maturity Date:	September 18, 2003
CUSIP Number:	912795NN7

High Rate: 0.945% Investment Rate 1/: 0.955% Price: 99.927

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 47.06%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 45,999,885	$ 17,956,405
Noncompetitive	43,827	43,827
FIMA (noncompetitive)	0	0
SUBTOTAL	46,043,712	18,000,232
Federal Reserve	3,106,001	3,106,001
TOTAL	$ 49,149,713	$ 21,106,233

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 = 46,043,712 / 18,000,232 = 2.56

1/ Equivalent coupon-issue yield.

JS 673

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 20, 2003
2003-8-20-14-42-47-29674

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 $80,916 million as of the end of that week, compared to $81,085 million as of the end of the prior week.

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

	August 8, 2003			August 15, 2003		
TOTAL		81,085			80,916	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	7,516	13,216	20,732	7,464	13,192	20,656
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,273	2,654	14,927	12,206	2,649	14,855
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]			22,740			22,726
3. Special Drawing Rights (SDRs) [2]			11,643			11,635
4. Gold Stock [3]			11,044			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	August 8, 2003			August 15, 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

	August 8, 2003			August 15, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions Headquartered in the U.S.						
3.c. With banks and other financial institutions Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

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

Reserves for the prior week are final.

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

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

August 25, 2003
JS-674

Treasury and IRS Issue Final Regulations On The Treatment of Stock-Based Compensation In Qualified Cost Sharing Arrangements

Today, the Treasury Department and the IRS issued final regulations on the tax treatment of stock-based compensation under the related party transfer pricing rules governing qualified cost sharing arrangements.

"It is critically important to ensure that related party transactions, particularly transactions involving cross-border transfers of valuable intangible assets, are treated appropriately for tax purposes," stated Treasury Assistant Secretary for Tax Policy Pamela Olson. "These final regulations represent a step in ensuring that the rules governing qualified cost sharing arrangements for the joint development of intangible assets reach results that are consistent with the arm's length standard of the transfer pricing rules and cannot be used to facilitate the migration of intangibles outside the United States for less than arm's length compensation. The Treasury Department is continuing to evaluate further regulatory steps that may be needed in this area."

In order for an arrangement to be considered a qualified cost sharing arrangement, the participants in the arrangement must share all costs related to the development of intangibles in the same proportion as they share the reasonably anticipated benefits attributable to the intangible development. The final regulations generally follow the proposed regulations that were published on July 29, 2002. As under the proposed regulations, the final regulations clarify that stock-based compensation, like other compensation, is taken into account in determining the costs of a participant.

The regulations also provide rules for measuring the cost associated with stock-based compensation, generally allowing taxpayers a choice of measuring the cost based on the stock price at the date of exercise or the "fair value", as noted in financial statements, at the date of grant. In response to comments on the proposed regulations, the availability of the fair value method of measurement has been expanded in the final regulations.

The text of the final regulations is attached.

-30-

Related Documents:

- final regulations text

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9088]

RIN 1545-BA57

Compensatory Stock Options Under Section 482

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the application of the rules of section 482 governing qualified cost sharing arrangements. These regulations provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements and for purposes of the comparability factors to be considered under the comparable profits method. .

DATES: Effective Date: These regulations are effective August 26, 2003.

Applicability Dates: For dates of applicability of these regulations, see §§1.482-1(j)(5) and 1.482-7(k).

FOR FURTHER INFORMATION CONTACT: Douglas Giblen, (202) 435-5265 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collections of information contained in these final regulations have 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) under control number 1545-1794. Responses to these collections of information are required by the IRS to monitor compliance with the federal tax rules for determining stock-based compensation costs to be shared among controlled participants in qualified cost sharing arrangements.

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

The estimated annual burden per respondent or recordkeeper varies from 2 hours to 7 hours, depending on individual circumstances, with an estimated average of 4 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden 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.

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

On July 29, 2002, Treasury and the IRS published in the **Federal Register** (67 FR 48997) proposed amendments to the regulations (REG-106359-02) under section 482 of the Internal Revenue Code (Code). These proposed regulations provide guidance regarding treatment of stock-based compensation for purposes of qualified cost sharing arrangements (QCSAs) and the comparable profits method and clarify the coordination of the rules regarding QCSAs with the arm's length standard. Written comments responding to these proposed regulations were received, and a public hearing was held on November 20, 2002. After consideration of all the comments, the proposed regulations under section 482 of the Code are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

These final regulations are the first in a series of regulatory guidance under section 482 through which Treasury and the IRS intend to update, clarify and improve current regulatory guidance in the transfer pricing area. A broader regulatory project on the treatment of QCSAs and a regulatory project on the transfer pricing of services are in progress, and Treasury and the IRS intend to issue proposed regulations with respect to each project in the near term.

These final regulations set forth explicit provisions clarifying that stock-based compensation is taken into account in determining the operating expenses treated as

intangible development costs of a controlled participant in a QCSA under §1.482-7. These final regulations provide rules for measuring the cost associated with stock-based compensation; clarify that the utilization and treatment of stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method under §1.482-5; and provide rules that coordinate the rules of §1.482-7 regarding QCSAs with the arm's length standard as set forth in §1.482-1.

Treasury and the IRS received comments with respect to the proposed regulations. Most commentators objected to the proposed regulations in their entirety or suggested postponement of their finalization. Some commentators suggested modifications to be adopted in the event that the proposed regulations were finalized in some form.

After fully considering these comments, Treasury and the IRS continue to believe that the proposed regulations reflect a sound application of established principles under section 482. At the same time, Treasury and the IRS have concluded that certain suggested modifications to the administrative provisions of the proposed regulations are appropriate. These modifications are incorporated into the final regulations.

A. Stock-Based Compensation as a Cost to Be Shared and the Arm's Length Standard as Applied to QCSAs -- §§1.482-7(d)(2)(i) and (a)(3), and 1.482-1(a)(1), (b)(2)(i) and (c)

A QCSA subject to the rules of §1.482-7 is an arrangement to develop intangibles which meets certain administrative and other requirements and in which the participants to the arrangement share intangible development costs in proportion to their shares of reasonably anticipated benefits attributable to the intangibles developed under

the arrangement. In the case of a QCSA, §1.482-7(a)(2) limits the ability of the Commissioner to make allocations, except to the extent necessary to make each controlled participant's share of the costs equal its share of reasonably anticipated benefits. An arrangement in which significant intangible development costs are not shared in proportion to reasonably anticipated benefits (or are not shared at all) would not in substance constitute an arrangement to which the rules of §1.482-7 are applicable.

The proposed regulations address the treatment of stock-based compensation under a QCSA, and the interaction between the rules applicable to QCSAs and the arm's length standard. The proposed regulations provide that stock-based compensation related to the covered intangible development area must be taken into account in determining the costs to be shared by participants in a QCSA. The proposed regulations further provide that a QCSA produces results consistent with an arm's length result if, and only if, all costs related to the intangible development, as determined in accordance with the specific guidance in §1.482-7(d), are shared in proportion to reasonably anticipated benefits.

Commentators objected to this rule on the basis of interpretations of the arm's length standard and on other grounds.

1. Comments relating to arm's length standard

Commentators asserted that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard unless there is evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Commentators asserted that third-party evidence, such as the

government's own procurement contracting practices and agreements between unrelated parties with some characteristics similar to QCSAs, would show that parties at arm's length do not take stock-based compensation into account in determining costs to be reimbursed.

Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." See H.R. Conf. Rep. No. 99-481, at II-638 (1986). The regulations relating to QCSAs implement that legislative intent by using costs incurred by each controlled participant with respect to the intangible development as a proxy for actual economic activity undertaken by each, and by requiring each controlled participant to share these costs in proportion to its anticipated economic benefit from intangibles developed pursuant to the arrangement. In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the

intangibles pursuant to the QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.

Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Section 1.482-1(b)(1) provides that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." (Emphasis added). While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. H.R. Rep. No. 99-426, at 423-25 (1985). The uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles to establish that parties at arm's length would not take stock options into account in the context of an arrangement similar to a QCSA. Government contractors that are entitled to reimbursement for services on a cost-plus basis under government procurement law assume substantially

less entrepreneurial risk than that assumed by service providers that participate in QCSAs, and therefore the economic relationship between the parties to such an arrangement is very different from the economic relationship between participants in a QCSA. The other agreements highlighted by commentators establish arrangements that differ significantly from QCSAs in that they provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement. Such terms, which may have the effect of mitigating the impact of using a cost base to be shared or reimbursed that is less than comprehensive, would not be permitted by the QCSA regulations. Further, the QCSA regulations would not allow the Commissioner to impose such terms in the context of a QCSA.

The regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles. These final regulations reflect that at arm's length the parties to an arrangement that is based on the sharing of costs to develop intangibles in order to obtain the benefit of an independent right to exploit such intangibles would ensure through bargaining that the arrangement reflected all relevant costs, including all costs of compensating employees for providing services related to the arrangement. Parties dealing at arm's length in such an arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation.

For example, assume that two parties are negotiating an arrangement similar to a QCSA in order to attempt to develop patentable pharmaceutical products, and that

they anticipate that they will benefit equally from their exploitation of such patents in their respective geographic markets. Assume further that one party is considering the commitment of several employees to perform research with respect to the arrangement. That party would not agree to commit employees to an arrangement that is based on the sharing of costs in order to obtain the benefit of independent exploitation rights unless the other party agrees to reimburse its share of the compensation costs of the employees. Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

An arrangement between controlled taxpayers for the development of intangible assets in which one taxpayer's share of significant costs exceeds its share of reasonably anticipated benefits from the exploitation of the developed intangibles would not in substance be a QCSA and therefore would be subject to analysis under the other section 482 regulations. For example, as in the transactions cited by commentators, a controlled taxpayer might agree at the outset of an arrangement to bear a disproportionate share of costs in an arrangement in which it receives a service fee or a contingent royalty from the exploitation of the developed intangibles. More generally, controlled taxpayers might agree at the outset of an arrangement to determine the compensation of one party based on a subset of that taxpayer's costs or on a basis that does not take that taxpayer's costs into account at all (e.g., based on an amount determined with reference to a comparable uncontrolled price or transaction). In either case, such an arrangement between controlled taxpayers would not in substance

constitute an arrangement to which the rules of §1.482-7 would apply. Indeed, the limitations contained in §1.482-7(a)(2) could produce results inconsistent with an arm's length result if applied to such an arrangement because the Commissioner would be precluded from making allocations that could be necessary to ensure that each controlled taxpayer is compensated appropriately. Rather, such an arrangement should be analyzed under the other section 482 regulations (in particular, sections 1.482-1, 1.482-2(b), and 1.482-4) to determine whether it reaches results consistent with the arm's length standard, and any allocations by the Commissioner should be consistent with such other section 482 regulations.

2. Other comments

Commentators offered various other reasons for not taking stock-based compensation into account in the context of QCSAs. Commentators expressed the view that stock-based compensation should not be taken into account because it does not constitute an economic cost or require a cash outlay, or, to the extent such compensation does constitute a cost, because the cost is borne by shareholders whose share value is diluted when additional shares are issued on exercise. Commentators also noted that the treatment of stock-based compensation for financial reporting purposes should not mandate that stock-based compensation be taken into account in the context of QCSAs.

In response to such views, and as discussed above, Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for in the context of QCSAs is appropriate. The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a

result is consistent with the arm's length standard. Treasury and the IRS agree that the disposition of financial reporting issues does not mandate a particular result under these regulations.

One commentator suggested that even if stock-based compensation generates a cost to a participant, there is precedent within the regulations relating to QCSAs for excluding certain costs, notably interest and taxes. Treasury and the IRS believe that the technical treatment under the regulations relating to QCSAs of interest, taxes and other expenses not related to the intangible development area does not warrant failing to take into account an element of employee compensation that is clearly related to the intangible development area. Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity consistent with the legislative intent in this area, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. As noted above, Treasury and the IRS do not believe that there is a basis for distinguishing between stock-based compensation and other forms of compensation in this context.

One commentator also claimed that the historical administrative practice of the IRS has been not to challenge the failure to take stock-based compensation into account in other transfer pricing contexts in which the determination of cost is relevant. Treasury and the IRS believe that such perceived practices of the IRS with respect to other section 482 contexts are not relevant to determining the appropriate regulatory rule applicable to QCSAs.

As an alternate approach, one commentator suggested that rather than requiring stock-based compensation to be taken into account in the QCSA context, Treasury and the IRS should promulgate a "stock-based compensation safe harbor" applicable to QCSAs. This suggested "safe harbor" has not been adopted in the final regulations. As noted above, Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. The final regulations therefore require employee compensation to be taken into account, rather than provide for a safe harbor under which such compensation could be ignored.

B. Grant-Date Identification Rule -- §1.482-7(d)(2)(ii)

The proposed regulations identify the stock-based compensation to be included in the cost pool based on whether the compensation is related to the intangible development area on the date the option is granted.

One commentator noted that this identification rule is inconsistent with the IRS treatment of stock-based compensation in other tax areas such as sourcing, where IRS rulings trace the compensation to the entire period over which the employee performed the services compensated by the option.

The grant-date identification rule has been retained in the final regulations. As noted in the preamble of the proposed regulations, it is desirable in the QCSA context to select a single date for identification of covered stock-based compensation. The grant of compensation generally is the single economic event most closely associated with the services being compensated.

C. Provision of Specific Methods of Measurement and Timing

The proposed regulations prescribe two alternative methods for determining the operating expenses attributable to stock-based compensation. The default rule under §1.482-7(d)(2)(iii)(A) provides that the costs attributable to stock-based compensation generally are included as intangible development costs upon the exercise of the option and measured by the spread between the option strike price and the price of the underlying stock. An elective rule under §1.482-7(d)(2)(iii)(B) provides that the costs attributable to stock options are taken into account in certain cases in accordance with the "fair value" of the option, as reported for financial accounting purposes either as a charge against income or in footnoted disclosures.

Commentators claimed that parties at arm's length would not use either of the alternatives prescribed in the proposed regulations because they would produce results that are too speculative or not sufficiently related to the employee services that are compensated. One commentator suggested that the final regulations should not limit taxpayers to the two prescribed measurement methods but rather should codify the current IRS administrative practice of permitting any reasonable method. In the commentator's view, a standard based on any reasonable method should permit the intrinsic-value method, which measures the difference between strike price and underlying stock value at date of grant, exclusive of time value. However, the commentator suggested that if Treasury and the IRS consider an element of time value indispensable, an alternative would be to require the use of the "minimum value" method, which accounts for the time value of stock options by assuming the underlying stock will grow at the risk-free interest rate.

These suggestions were not adopted. Treasury and the IRS believe that it is appropriate for regulations to prescribe guidance in this context that is consistent with the arm's length standard and that also is objective and administrable. As long as the measurement method is determined at or before grant date, either of the prescribed measurement methods can be expected to result in an appropriate allocation of costs among QCSA participants and therefore would be consistent with the arm's length standard. The results under the default measurement rule are consistent with what would occur under an arm's length agreement at or before the grant date to take stock-based compensation into account at the date of exercise when more facts are known and therefore to share the risks associated with such compensation between the date of grant and the date of exercise. The results under the elective measurement rule are consistent with what would occur under an alternative arm's length agreement at or before the grant date to determine the value of the compensation up front and take such compensation into account at that time. With respect to the specific methods proposed by commentators, Treasury and the IRS believe that "intrinsic value" ignores significant elements of the economic value of stock-based compensation and "minimum value" ignores the important variable of volatility that enters into the economic pricing models used for financial reporting purposes.

The prescribed measurement methods are objective and administrable because they rely on valuations or measurements of stock-based compensation prepared for other purposes. The prescribed measurement methods do not require or permit valuations of stock-based compensation specifically for QCSA purposes. A standard under which the validity of the taxpayer's method would have to be analyzed on a case-

by-case basis would be unduly difficult to administer and potentially could lead to significant disputes.

D. General Rule of Measurement -- §1.482-7(d)(2)(iii)(A)

Under the default measurement rule, the amount taken into account for QCSA purposes generally is the amount allowable as a federal income tax deduction on exercise of the stock-based compensation. This amount generally is the "spread" between the option price and the fair market value of the underlying stock at the date of exercise.

One commentator suggested that this method would be improved if the amount taken into account for QCSA purposes were limited to the portion of the spread that accrued between date of grant and full vesting, as further prorated to reflect only the time during which the employee was engaged in cost-shared activities.

This suggestion has not been adopted in the final regulations. Treasury and the IRS believe that the grant-date identification rule already limits in an appropriate way the stock-based compensation taken into account. The purpose of the default measurement rule is to measure the amount attributable to stock-based compensation that must be taken into account under the grant-date identification rule. Accordingly, the default measurement rule does not require further refinement through proration. Further, additional recordkeeping and analysis necessary to identify relevant time periods and employee activities involving the covered intangibles and to perform proration calculations are not warranted.

The proposed regulations set forth special rules for the application of the general rule of measurement in the event of modification of a stock option and expiration or termination of a QCSA. The final regulations retain these rules with technical modifications.

E. Treatment of Statutory Stock Options -- §1.482-7(d)(2)(iii)(A)(1)

Under the default measurement rule in the proposed regulations, a special rule applies to statutory stock options (also referred to as incentive and employee stock purchase plan stock options). Under this special rule, the spread on statutory stock options generally is taken into account for QCSA purposes on exercise, even though section 421 denies a deduction with respect to statutory stock options unless and until there is a disqualifying disposition of the underlying stock by the employee.

One commentator suggested that the special rule for statutory stock options should be removed because it imposes an unnecessary administrative burden on taxpayers to apply different rules for different purposes. This suggestion was not adopted in the final regulations. Treasury and the IRS believe that the more important concern is consistent treatment of statutory and nonstatutory stock options for this purpose. This consistency is achieved only if the spread on both statutory and nonstatutory options is included in the cost pool on exercise.

F. Elective Method of Measurement -- §1.482-7(d)(2)(iii)(B)

The proposed regulations permit an elective method of measurement and timing with respect to options on publicly traded stock of companies subject to financial reporting under U.S. generally accepted accounting principles (U.S. GAAP), provided that the stock is traded on a U.S. securities market. Under the election, the amount taken into account for QCSA purposes associated with compensatory stock options is their "fair value," generally measured by reference to economic pricing models as of the date of grant, as reflected either as a charge against income or as a footnote disclosure in the company's audited financial statements, in compliance with current U.S. GAAP.

One commentator proposed that the elective measurement method be made available to all taxpayers. The commentator further suggested that controlled participants should be permitted to use any reasonable method to measure stock-based compensation in the form of options on stock of foreign corporations as long as that method is consistent with international accounting standards or with accounting principles that are prevalent in the home country of the controlled participant. In the commentator's view, the limitations in the proposed regulations are not justified by difficulty of valuation and may be vulnerable to challenges under anti-discrimination clauses in U.S. income tax treaties.

Treasury and the IRS agree that the elective method should be more broadly available and have modified these rules in the final regulations. Specifically, the final regulations extend the availability of the elective method to options on the stock of certain companies that prepare their financial statements in accordance with accounting principles other than U.S. GAAP, while continuing to limit the availability of the elective method to options on stock that is publicly traded on a U.S. securities market. Thus, the availability of the elective method is not extended to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

Treasury and the IRS believe that objectivity and ease of administration are important features of any method of measuring costs attributable to stock-based compensation for purposes of QCSAs. The elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Treasury and the IRS recognize that foreign-based companies whose stock is traded on a U.S.

securities market (directly or through the use of American Depository Receipts) are required to determine the fair value of options on their stock even though they do not necessarily prepare financial statements in accordance with U.S. GAAP. Companies satisfy that requirement by preparing financial statements in accordance with a comprehensive body of generally accepted accounting principles (GAAP) that is consistent with the U.S. GAAP requirement of determining the fair value of stock options, or by preparing reconciliations of their financial statements with U.S. GAAP in a manner that reflects the fair value of stock options.

Accordingly, the final regulations provide that in determining eligibility for the elective method, financial statements prepared in accordance with GAAP other than U.S. GAAP are considered as prepared in accordance with U.S. GAAP in two circumstances. First, financial statements are considered as prepared in accordance with U.S. GAAP where the fair value of stock options is reflected in a legally required reconciliation between the applicable GAAP and U.S. GAAP. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such reconciliation. Second, financial statements are considered as prepared in accordance with U.S. GAAP where, under the applicable GAAP, the fair value of stock options is reflected as a charge against income in audited financial statements or is disclosed in footnotes to such statements. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such audited financial statements.

Treasury and the IRS continue to believe that the elective method should be available only for options on stock whose value is readily determinable and for

companies that are required to determine the fair value of stock options for a non-tax purpose. Accordingly, the final regulations do not extend the availability of the elective method to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

One commentator suggested that the election to use the elective method should be made on the taxpayer's return rather than evidenced in the written cost sharing agreement. In the view of the commentator, such a procedure would be more practical from an enforcement perspective.

This suggestion was not adopted. Treasury and the IRS continue to believe that the most effective way to ensure that all participants are bound by the election is to incorporate it within the written cost sharing agreement.

G. Modification of Comparable Profits Method -- §1.482-5(c)(2)(iv)

The proposed regulations provide that in applying the comparable profits method, if there are material differences among the tested party and uncontrolled comparables with respect to the utilization or treatment of stock-based compensation, such material differences are an appropriate basis for comparability adjustments. One commentator expressed the view that this provision contradicts the arm's length coordination rules for QCSAs because the treatment of stock-based compensation by unrelated parties is considered relevant for purposes of the comparable profits method but not relevant for purposes of QCSAs.

No revision was made in response to this comment. Treasury and the IRS believe that the rule provided in the proposed regulations with respect to the application of the comparable profits method is appropriate because the financial data with respect

to similar business activities that generally is used as a reference point for that method is subject to adjustment to ensure comparability.

H. Effective Date and Transition Rules -- §1.482-7(k) and (d)(2)(iii)(B)(2)

The provisions of the proposed regulations applicable to QCSAs would apply to stock-based compensation granted in taxable years beginning on or after publication of final regulations. Participants in a QCSA in existence on the effective date may, on a one-time basis, amend their agreement to elect the grant-date method of measurement without the Commissioner's consent. The election with respect to existing QCSAs must be made not later than the latest due date, without regard to extensions, for an income tax return of a controlled participant for the first taxable year beginning after the effective date of final regulations.

One commentator stated that the prospective effective date does not afford taxpayers a reasonable time to amend their cost sharing agreements or restructure complex international operations. A transition period of two years after the publication of final regulations was suggested.

This suggestion was not adopted. Treasury and the IRS consider the period stated in the proposed regulations adequate for the initial planning and recordkeeping that may be occasioned by the final regulations.

With respect to the special transition rule permitting taxpayers to elect the grant-date method of measurement by amendment of an existing written cost sharing agreement no later than the latest due date of an income tax return of a controlled participant, one commentator suggested that the due date should not disregard filing

extensions. The commentator maintained that fairness dictates affording taxpayers this extra time for the analysis needed to make this significant decision.

In response to this comment, the final regulations provide that the due date for amendments to existing cost sharing agreements is determined with regard to filing extensions.

Some commentators urged Treasury and the IRS to postpone finalization of the proposed regulations until the OECD completes its ongoing consideration of the treatment of stock options for transfer pricing purposes and an international consensus begins to form so that the potential for international disputes and resulting negative effects on U.S. business can be minimized. Similarly, a commentator suggested that the effects of applying the principles of the proposed regulations to other areas of transfer pricing should be thoroughly studied and harmonized before finalizing the regulations to avoid creating traps for the unwary or other unforeseen consequences.

These suggestions were not implemented. Treasury and the IRS do not believe that international discussion of issues compels the suspension of the regulatory process. Also, Treasury and the IRS believe that it is important to provide timely guidance on issues such as those addressed by the proposed and final regulations.

Finally, the preamble to the proposed regulations states that the proposed regulations clarify that stock-based compensation must be taken into account in the QCSA context. Several commentators interpreted this language as in effect requiring the new rules to be applied retroactively. These commentators urged that the final regulations contain further assurances of prospective intent and explicitly recognize that

these regulations represent a fundamental change to the traditional approach to section 482.

No revisions were made in light of these comments. As noted earlier, Treasury and the IRS believe that requiring stock-based compensation to be taken into account in the QCSA context is consistent with the arm's length standard and long-standing policies underlying section 482. The final regulations, like the proposed regulations, clearly specify that the specific rules provided therein are prospective in application. Moreover, as stated in the proposed regulations, while taxpayers may rely on the proposed regulations until the effective date of the final regulations, no inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of these final regulations.

I. Paperwork Reduction Act and Regulatory Flexibility Act

One commentator expressed the view that the compliance burden imposed by the proposed regulations on each taxpayer will significantly exceed the two to seven hours estimated under the Paperwork Reduction Act. The commentator also asserted that the estimated number of taxpayers affected by the rules was too low.

The burden estimates as stated in the final regulations reflect no change. Treasury and the IRS reviewed the estimates made in the proposed regulations and concluded that they are reasonable.

Similarly, with respect to the Regulatory Flexibility Act, the commentator challenged the statement in the preamble of the proposed regulations that the new regulatory requirements will not have a significant economic impact on a substantial number of small entities. Upon review of available information, Treasury and the IRS

found no basis for a change in the statement or in the operative finding that the economic impact of the collections of information in the proposed regulations is not significant with respect to small entities.

J. Documentation Requirements and Other Provisions on Which No Comments Received

Section 1.482-7(j)(2)(i)(F) of the proposed regulations requires that controlled participants maintain specific documentation to establish the amount attributable to stock-based compensation that is taken into account in determining the costs to be shared, including the method of measurement and timing used with respect to that amount. No comments were received on this particular provision, and it is retained in the final regulations.

Treasury and the IRS intend that this provision will require controlled participants that use the elective method of measurement to maintain documentation establishing compliance with the requirements of §1.482-7(d)(2)(iii)(B). For example, documentation should establish that applicable financial statements reflecting the value of stock options with respect to which the elective method is used, as well as applicable accounting principles under which such financial statements are prepared, are in conformity with the fair-value and reconciliation requirements adopted in the final regulations with respect to GAAP other than U.S. GAAP.

Several other provisions of the proposed regulations similarly were not commented upon and have been adopted without modification in the final regulations. These provisions include §1.482-7(d)(2)(iii)(A)(2), relating to deductions of foreign controlled participants; the last sentence of §1.482-7(d)(2)(ii), relating to repricing and

other modifications of stock options; and §1.482-7(d)(2)(iii)(C), providing consistency rules for measurement and timing of stock-based compensation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. 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 fact that few small entities are expected to enter into QCSAs involving stock-based compensation, and that for those who do, the burdens imposed under §1.482-7(d)(2)(iii)(B) and (j)(2)(i)(F) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Douglas Giblen of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS 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 parts 1 and 602 are 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 * * *

Sections 1.482-1, 1.482-5 and 1.482-7 also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.482-0 is amended by:

1. Redesignating the entry for §1.482-7(a)(3) as the entry for §1.482-7(a)(4).

2. Adding a new entry for §1.482-7(a)(3).

3. Redesignating the entry for §1.482-7(d)(2) as the entry for §1.482-7(d)(3).

4. Adding new entries for §1.482-7(d)(2).

The additions and redesignation read as follows:

§1.482-0 Outline of regulations under section 482.

* * * * *

§1.482-7 Sharing of costs.

(a) In general.
* * * * *
(3) Coordination with §1.482-1.
(4) Cross references.
* * * * *
(d) Costs.
* * * * *
(2) Stock-based compensation.
(i) In general.
(ii) Identification of stock-based compensation related to intangible development.
(iii) Measurement and timing of stock-based compensation expense.

(A) In general.
(1) Transfers to which section 421 applies.
(2) Deductions of foreign controlled participants.
(3) Modification of stock option.
(4) Expiration or termination of qualified cost sharing arrangement.
(B) Election with respect to options on publicly traded stock.
(1) In general.
(2) Publicly traded stock.
(3) Generally accepted accounting principles.
(4) Time and manner of making the election.
(C) Consistency.
(3) Examples.
* * * * *

Par. 3. Section 1.482-1 is amended by:

1. Removing the sixth sentence of paragraph (a)(1) and adding two sentences in its place.

2. Adding a sentence at the end of paragraph (b)(2)(i).

3. Adding a sentence at the end of paragraph (c)(1).

4. Adding paragraph (j)(5).

The additions read as follows:

§1.482-1 Allocation of income and deductions among taxpayers.

(a) * * *

(1) * * * Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. * * *

* * * * *

(b) * * *

(2) * * *

(i) * * * Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

(c) * * *

(1) * * * See §1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

* * * * *

(j) * * *

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of §1.482-5 apply for taxable years beginning on or after August 26, 2003.

Par. 4. Section 1.482-5 is amended by adding a sentence at the end of paragraph (c)(2)(iv) to read as follows:

§1.482-5 Comparable profits method.

* * * * *

(c) * * *

(2) * * *

(iv) * * * As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by §1.482-7(d)(2)(i)) among the tested party and comparable parties.

* * * * *

Par. 5. Section 1.482-7 is amended by:

1. Redesignating paragraph (a)(3) as paragraph (a)(4).

2. Adding a new paragraph (a)(3).

3. Redesignating paragraph (d)(2) as paragraph (d)(3).

4. Adding a new paragraph (d)(2).

5. Removing the word "and" at the end of paragraph (j)(2)(i)(D).

6. Removing the period at the end of paragraph (j)(2)(i)(E) and adding "; and" in its place.

7. Adding paragraph (j)(2)(i)(F).

8. Revising paragraph (k).

The additions and revision read as follows:

§1.482-7 Sharing of costs.

(a) * * *

(3) Coordination with §1.482-1. A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of §1.482-1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

* * * * *

(d) * * *

(2) Stock-based compensation--(i) In general. For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) Identification of stock-based compensation related to intangible development. The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) Measurement and timing of stock-based compensation expense--(A) In general. Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to

the controlled participant as a deduction for Federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(1) Transfers to which section 421 applies. Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(2) Deductions of foreign controlled participants. Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(3) Modification of stock option. Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(4) Expiration or termination of qualified cost sharing arrangement. Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) Election with respect to options on publicly traded stock --(1) In general. With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(2) Publicly traded stock. As used in this paragraph (d)(2)(iii)(B), the term publicly traded stock means stock that is regularly traded on an established United

States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(3) Generally accepted accounting principles. For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either--

(i) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(ii) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(4) Time and manner of making the election. The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a

qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) Consistency. Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(2) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the

Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

* * * * *

(j) * * *

(2) * * *

(i) * * *

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of covered intangibles.

* * * * *

(k) Effective date. This section applies for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

* * * * *

PART 602–OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 10. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read in part as follows :

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.482-7	1545-1794
* * * * *	

Deputy Commissioner for Services and Enforcement.

Robert E. Wenzel

Approved: August 11, 2003

Assistant Secretary of the Treasury.

Pamela F. Olson

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 25, 2003
JS-675

Treasury Issues Final Regulations On Treatment Of Income From International Operation Of Ships And Aircraft

Today the Treasury Department issued final regulations regarding the treatment of income derived by foreign corporations from the international operation of ships or aircraft. These regulations generally follow regulations that were issued in proposed form in August 2002, with some modifications in response to comments received.

A foreign corporation's income from the international operation of ships or aircraft generally is exempt from U.S. tax if the foreign corporation is organized in a country that provides an equivalent exemption to U.S. corporations under its domestic law or under a diplomatic agreement with the United States.

The regulations provide guidance on the scope of this exemption and set forth certain information reporting requirements for foreign corporations claiming this exemption. In particular, the regulations provide guidance on when a foreign corporation is to be considered engaged in the international operation of ships or aircraft, and when a foreign country is to be considered to provide an equivalent exemption.

The regulations also provide detailed guidance on the types of income that qualify for the exemption. Generally, the exemption is available for income from the international carriage of passengers and cargo and from certain activities that are incidental to the international operation of ships or aircraft, such as the sale of tickets for another airline under a code-sharing arrangement.

In addition, the regulations provide guidance regarding the ownership requirements for foreign corporations claiming the exemption. Generally, the exemption is available to foreign corporations that are majority-owned by residents of the country in which they are incorporated (or of another country that provides a reciprocal exemption to U.S. corporations) or that are publicly traded and widely held. The regulations provide detailed rules regarding the information required for foreign corporations to substantiate that they meet the applicable ownership requirements.

The text of the final regulations is attached.

Related Documents:

- final regulations text

[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD9087]

RIN 1545-BA07

Exclusions From Gross Income of Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations implementing sections 883(a) and (c) that relate to income derived by foreign corporations from the international operation of ships or aircraft. The final regulations reflect changes made by the Tax Reform Act of 1986 and subsequent legislative amendments. The final regulations provide, in general, that a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships or aircraft shall exclude qualified income from gross income for purposes of U.S. Federal income taxation, provided that the corporation can satisfy certain ownership and related documentation requirements. The final regulations explain when a foreign country is a qualified foreign country and what

129 pp.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 26, 2003
JS-676

U.S. Treasury to Hold First U.S.-Brazil Group for Growth Meeting

On Wednesday, August 27, 2003, U.S. Treasury officials and officials of the Brazilian Finance Ministry will hold the first session of the U.S.-Brazil Group for Growth.

The U.S. delegation will be chaired by John B. Taylor, Under Secretary for International Affairs at the Department of Treasury. U.S. participants will include Federal Reserve Governor Ben Bernanke and Council of Economic Advisors member-designate Kristin Forbes. The Brazilian delegation will be co-chaired by Joaquim V. Levy, Secretary of the National Treasury, and Marcos Lisboa, Secretary for Economic Policy, both at the Ministry of Finance. Brazilian participants will also include Brazilian Ambassador to the United States Rubens Barbosa and Brazilian Executive Director to the IMF Murillo Portugal. The Group for Growth was initiated by President Bush and President Lula of Brazil in June.

Brazil and U.S. delegations will hold discussions on the determinants of growth and measures to boost small- and medium-sized enterprises, including access to credit and capital markets. The meeting will also offer a venue for each side to present an overview on recent growth performance and discuss recent trends and prospects in the fiscal area. Both the United States and Brazil are putting in place policies to raise growth, with voting on key reform legislation in Brazil and the implementation of major jobs and growth legislation in the United States. Closer understanding of the underpinnings of economic activity and reforms in each country is thus of mutual interest and would benefit the hemisphere.

A photo opportunity will be held at the conclusion of the meetings and a press briefing with U.S. and Brazil officials will follow.

U.S.-Brazil Group for Growth
Under Secretary John Taylor, U.S. Treasury
Joaquim V. Levy, Brazil Secretary of the National Treasury
Marcos Lisboa, Brazil Secretary for Economic Policy
9:00-1:45 PM
U.S. Department of the Treasury, Room 4121
1500 Pennsylvania Ave NW
Washington, DC

*** 1:30PM– Photo Opportunity – Office of U/S John Taylor (Room 3432)**
*** 1:45PM - Press Availability - Media Room (Room 4121)**

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 27, 2003
JS-678

U.S.-Brazil Group for Growth

The United States and Brazil held the first meeting of the Group for Growth today in Washington, D.C. Formation of the Group was announced at the June 2003 meeting between President Bush and President Lula with the goal of developing strategies to raise economic growth in both countries.

The U.S. delegation was chaired by John B. Taylor, Under Secretary for International Affairs at the Department of Treasury. U.S. participants included Federal Reserve Governor Ben Bernanke and Council of Economic Advisors member-designate Kristin Forbes. The Brazilian delegation was co-chaired by Joaquim V. Levy, Secretary of the National Treasury, and Marcos Lisboa, Secretary for Economic Policy, both at the Ministry of Finance. Brazilian participants included Brazilian Ambassador to the United States Rubens Barbosa and Brazilian Executive Director to the IMF Murilo Portugal.

During the meeting, the delegations discussed the measures for raising productivity growth in both countries, including tax and pension reform in Brazil and the major jobs and growth legislation in the United States. The Brazilian representatives also reported on their government's initiatives for expanding access to credit for microenterprises and small- and medium-sized enterprises.

"The Lula Administration is taking very significant steps to increase economic growth in Brazil," John Taylor said. "The pension and tax reforms proposed by President Lula address some of the most fundamental fiscal challenges facing Brazil. The United States strongly supports the government's efforts."

"The strength of the U.S. economy provides convincing evidence of the importance of competition to foster economic growth," Marcos Lisboa said. For his part, Joaquim Levy noted that "a well developed capital market that helps funnel savings to productive investment—including by small businesses—is a major factor to ensure growth, innovation, and lower costs to finance public debt." Both were confident that policy measures taken by the U.S. government in recent months will help accelerate the recovery of the U.S. economy, which is expected to have positive spillover effects for the rest of the world.

The Group agreed to reconvene in Brazil in the first quarter of 2004.

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
August 27, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Interest Rate:	2%	Issue Date:	September 02, 2003
Series:	P-2005	Dated Date:	August 31, 2003
CUSIP No:	912828BJ8	Maturity Date:	August 31, 2005

High Yield: 2.040% Price: 99.922

All noncompetitive and successful competitive bidders were awarded securities at the high yield. Tenders at the high yield were allotted 0.89%. All tenders at lower yields were accepted in full.

Accrued interest of $ 0.10989 per $1,000 must be paid for the period from August 31, 2003 to September 02, 2003.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 42,304,813	$ 24,163,268
Noncompetitive	836,794	836,794
FIMA (noncompetitive)	0	0
SUBTOTAL	43,141,607	25,000,062 1/
Federal Reserve	5,589,867	5,589,867
TOTAL	$ 48,731,474	$ 30,589,929

Median yield 1.998%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low yield 1.950%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 43,141,607 / 25,000,062 = 1.73

1/ Awards to TREASURY DIRECT = $620,025,000

JS 679

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
August 25, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	August 28, 2003
Maturity Date:	February 26, 2004
CUSIP Number:	912795PM7

High Rate: 1.040% Investment Rate 1/: 1.063% Price: 99.474

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 79.83%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 30,345,226	$ 14,074,296
Noncompetitive	1,351,479	1,351,479
FIMA (noncompetitive)	574,500	574,500
SUBTOTAL	32,271,205	16,000,275 2/
Federal Reserve	5,735,903	5,735,903
TOTAL	$ 38,007,108	$ 21,736,178

Median rate 1.030%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.000%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 32,271,205 / 16,000,275 = 2.02

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $998,645,000

JS-640

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
August 25, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	92-Day Bill
Issue Date:	August 28, 2003
Maturity Date:	November 28, 2003
CUSIP Number:	912795NY3

High Rate: 0.980% Investment Rate 1/: 0.997% Price: 99.750

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 45.34%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 31,055,248	$ 14,131,368
Noncompetitive	1,483,002	1,483,002
FIMA (noncompetitive)	385,800	385,800
SUBTOTAL	32,924,050	16,000,170 2/
Federal Reserve	5,570,281	5,570,281
TOTAL	$ 38,494,331	$ 21,570,451

Median rate 0.965%: 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 = 32,924,050 / 16,000,170 = 2.06

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,183,020,000

JS-681

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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

AMENDED AUGUST 25, 2003 3:25 P.M.

EMBARGOED UNTIL 11:00 A.M.
August 25, 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 $13,075 million of publicly held notes maturing August 31, 2003, and to raise new cash of approximately $11,925 million.

In addition to the public holdings, Federal Reserve Banks hold $5,590 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 $538 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 683

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF
2-YEAR NOTES TO BE ISSUED SEPTEMBER 2, 2003

August 25, 2003

Offering Amount	$25,000 million
Maximum Award (35% of Offering Amount)	$ 8,750 million
Maximum Recognized Bid at a Single Yield	$ 8,750 million
NLP Reporting Threshold	$ 8,750 million

Description of Offering:

Term and type of security	2-year notes
Series	P-2005
CUSIP number	912828 BJ 8
Auction date	August 27, 2003
Issue date	September 2, 2003
Dated date	August 31, 2003
Maturity date	August 31, 2005
Interest rate	Determined based on the highest accepted competitive bid
Yield	Determined at auction
Interest payment dates	The last calendar day of February and August through August 31, 2005
Minimum bid amount and multiples	$1,000
Accrued interest payable by investor	Determined at auction
Premium or discount	Determined at auction

STRIPS Information:

Minimum amount required	$1,000
Corpus CUSIP number	912820 JF 5
Due date(s) and CUSIP number(s) for additional TINT(s)	August 31, 2005 - - 912833 ZN 3

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.

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.
August 25, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $26,000 million to refund an estimated $20,000 million of publicly held 4-week Treasury bills maturing August 28, 2003, and to raise new cash of approximately $6,000 million.

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

The Federal Reserve System holds $14,592 million of the Treasury bills maturing on August 28, 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-684

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED AUGUST 28, 2003

August 25, 2003

Offering Amount	$26,000 million
Maximum Award (35% of Offering Amount)	$ 9,100 million
Maximum Recognized Bid at a Single Rate	$ 9,100 million
NLP Reporting Threshold	$ 9,100 million
NLP Exclusion Amount	$11,800 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 NP 2
Auction date	August 26, 2003
Issue date	August 28, 2003
Maturity date	September 25, 2003
Original issue date	March 27, 2003
Currently outstanding	$45,900 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

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August 28, 2003
JS-685

Treasury Issues Proposed Regulations on Tax Treatment of Foreign Currency Contingent Payment Debt Instruments

Today the Treasury Department issued proposed regulations providing detailed rules on the tax treatment of contingent payment debt instruments that are denominated in a foreign currency.

Existing regulations provide guidance on the tax treatment of non-contingent debt instruments denominated in foreign currency, and on contingent payment debt instruments not denominated in foreign currency. The proposed regulations fill the regulatory gap between these two existing sets of rules.

In general, the proposed regulations apply the so-called "non-contingent bond method" provided in regulations under section 1275 to the debt instrument in the currency in which it is denominated. The resulting amounts then are translated into the taxpayer's functional currency, and gain or loss determined, under rules similar to the existing rules for non-contingent foreign currency-denominated debt instruments. The proposed regulations generally follow the methodology that was described in Announcement 99-76.

Related Documents:

- The text of the proposed regulations

[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106486-98; INTL-0015-91]

RIN 1545-AW33; RIN 1545-PP78

Guidance Regarding the Treatment of Certain Contingent Payment Debt Instruments with One or More Payments that Are Denominated in, or Determined by Reference to, a Nonfunctional Currency

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of public hearing; and withdrawal of previous proposed regulations section.

SUMMARY: This document contains proposed regulations regarding the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's functional currency. These regulations are necessary because current regulations do not provide guidance concerning the tax treatment of such instruments. The proposed regulations generally provide that taxpayers should apply the existing rules under section 1275 of the Internal Revenue Code, with certain modifications, to nonfunctional currency contingent payment debt instruments. This document also withdraws existing proposed regulations and provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for December 3, 2003, at 10 a.m. must be submitted by November 12, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-106486-98), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to: REG-106486-98, Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. or sent electronically, via the IRS Internet site at: www.irs.gov/regs. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Milton Cahn at (202) 622-3870; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

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 collection of Information should be received by October 28, 2003. Comments are specifically requested concerning:

Whether the proposed collections of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, 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 collections 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 service to provide information.

The collections of information in this proposed regulation are in §1.988-6(a)(1) (cross reference to §1.1275-4) and §1.988-6(d)(3). This information is required to ensure consistency in the treatment of the debt instrument between the issuer and the holders. This information will be used for audit and examination purposes. The disclosure of information is mandatory as regards the issuers of nonfunctional currency contingent payment debt instruments. The reporting of information is mandatory as regards holders of debt instruments which determine their own projected payment schedule. The recordkeeping requirement is mandatory for any party that determines the comparable yield and projected payment schedule for a debt instrument. The likely respondents are business or other for-profit institutions.

Taxpayers provide the information on a statement attached to its timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

Estimated total annual reporting, and/or recordkeeping burden: 100 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 1 hour.

Estimated number of respondents and/or recordkeepers: 100

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

On March 17, 1992, Treasury and the IRS issued proposed regulations (INTL-0015-91), §§1.988-1(a)(3), (4) and (5), regarding contingent payment debt instruments, dual currency debt instruments and multi-currency debt instruments. The proposed regulations followed the general approach in the then-proposed §1.1275-4(g) contingent payment debt regulations (LR-189-84; 51 FR 12022 (1986), amended at 56 FR 8308 (1991)) and bifurcated such debt instruments into contingent and noncontingent components. After an instrument was bifurcated, the proposed regulations applied the rules in §§1.988-1 through 1.988-5, as appropriate, to the resulting components.

On December 16, 1994, Treasury and the IRS withdrew the then proposed §1.1275-4(g) regulations and proposed a new set of §1.1275-4 regulations (FI-59-91, 59 FR-64884). These regulations were finalized on June 14, 1996.

Section 1.1275-4 of the final regulations adopted the "noncontingent bond method" for certain contingent payment debt instruments. Under the noncontingent bond method, interest

accrues on a contingent payment debt instrument at a rate equal to the instrument's comparable yield, which is the yield at which an issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. In addition, the noncontingent bond method treats all interest on a debt instrument as original issue discount, which must be taken into account as it accrues, regardless of the taxpayer's normal method of accounting.

Under the noncontingent bond method, the comparable yield is used to construct a projected payment schedule for the debt instrument, which includes a projected amount for each contingent payment. If the actual amount of a contingent payment is greater than the projected amount, the difference is treated as additional interest. If the actual amount of a contingent payment is less than the projected amount, the difference generally offsets current interest accruals. In some cases, the difference may result in a loss to the holder and income to the issuer.

On August 2, 1999, as a result of the withdrawal of the 1994 proposed §1.1275-4(g) regulations and the promulgation of the final §1.1275-4 regulations, the IRS issued Announcement 99-76 (1999-2 C.B. 223) which provided a description of a regulatory approach that Treasury and the IRS were considering as a replacement to the proposed regulations in §§1.988-1(a)(3), (4) and (5) for contingent payment debt instruments with one or more payments denominated in, or determined by reference to, a nonfunctional currency. Announcement 99-76 stated that Treasury and the IRS were considering issuing regulations that would apply the noncontingent bond method in the taxpayer's nonfunctional currency and would translate payments received on the instrument into functional currency under the rules of §§1.988-1 through 1.988-5. Announcement 99-76 requested comments on this approach. No comments

were received.

Treasury and the IRS believe that proposed regulations §1.988-1(a)(3), (4) and (5) should be withdrawn because they incorporate the bifurcation approach rather than the noncontingent bond method ultimately adopted under §1.1275-4. Treasury and the IRS believe, as reflected in Announcement 99-76, that nonfunctional currency contingent payment debt instruments should be accounted for under rules similar to those that govern the treatment of functional currency contingent payment debt instruments. Treasury and the IRS believe that providing a consistent set of rules in this area is in the best interests of sound tax administration.

Explanation of Provisions

In General

These proposed regulations provide guidance for four different types of debt instruments: (1) debt instruments issued for money or publicly-traded property for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which have one or more non-currency contingencies, (2) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which have no non-currency contingencies, (3) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which also have one or more non-currency contingencies, and (4) debt instruments which otherwise would fall into one of the three foregoing categories but for the fact that the instruments are not issued for money or publicly-traded property. These proposed regulations do not discuss the treatment of tax-exempt obligations described in §1.1275-4(d)

which are denominated in one or more nonfunctional currencies. Comments are requested as to the proper treatment of such instruments.

Consistent with the approach described in Announcement 99-76, these proposed regulations generally apply the rules of §1.1275-4(b) (i.e., the noncontingent bond method) to nonfunctional currency contingent payment debt instruments issued for money or publicly traded property. The proposed regulations generally provide that the noncontingent bond method is applied in the currency in which the instrument is denominated (the denomination currency).

Application of the §1.1275-4(b) rules to nonfunctional currency contingent instruments generally requires taxpayers (i) to accrue interest in the denomination currency at a yield at which the issuer would issue a fixed rate debt instrument denominated in the denomination currency with terms and conditions similar to those of the contingent payment debt instrument, (ii) to translate the interest accrued from the denomination currency into the functional currency (and account for foreign currency gain or loss on payments of interest and principal) under the principles of §1.988-2(b), and (iii) to account for gain or loss arising from contingencies in a manner consistent with the rules of §1.1275-4(b).

Applying the Noncontingent Bond Method in the Denomination Currency

As noted, the proposed regulations require taxpayers to apply the noncontingent bond method in the instrument's denomination currency. For example, in the case of an instrument whose denomination currency is the British pound, an issuer whose functional currency is the U.S. dollar would first determine the comparable yield of the instrument, that is, the yield at which the issuer would issue a fixed rate instrument in British pounds with terms and conditions similar to those of the instrument actually being issued. Second, the issuer would construct a

projected payment schedule applying that yield. Third, the amount of interest accrued in each taxable year would be determined in British pounds based on the comparable yield and translated into dollars under the principles of section 988. Fourth, the issuer and holder would account for differences between the projected amount of payments and the actual amount of payments (so-called positive adjustments and negative adjustments) under rules similar to those in §1.1275-4(b). Consistent with the rules of §1.1275-4(b), the proposed regulations provide that net positive adjustments are treated as additional interest on the instrument. Net negative adjustments generally offset current interest accruals, and in some cases may result in a loss to the holder and income to the issuer. Finally, the issuer and holders would determine foreign currency gain or loss with respect to interest and principal payments on the instrument.

Determination of the comparable yield and projected payment schedule

Consistent with §1.1275-4(b)(4)(iv), the holder uses the yield and projected payment schedule determined by the issuer to determine the holder's interest accruals and adjustments for a debt instrument. If the issuer does not determine a comparable yield and projected payment schedule for the debt instrument, or if the issuer's comparable yield or projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and the projected payment schedule for the debt instrument under the rules of the proposed regulations. A holder that determines its own comparable yield and projected payment schedule must explicitly disclose, in the manner set forth in §1.1275-4(b)(4)(iv), both this fact and the reason why the holder made its own determination.

Determination of Basis

In general, the proposed regulations provide that a holder maintains its adjusted basis in

functional currency by computing basis adjustments in the denomination currency under the rules of §1.1275-4(b)(7)(iii) and then translating such adjustments into functional currency. Thus, the proposed regulations provide that a holder's basis is increased by the holder's accrued but unpaid interest inclusions on the debt instrument, generally without regard to any positive or negative adjustments, and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. These amounts are translated into functional currency under the principles of §1.988-2(b).

Determination of Amount Realized

The proposed regulations generally follow §1.1275-4(b)(7)(iv) in determining the amount realized, but do so in the denomination currency. Thus, for purposes of determining the amount realized by a holder on the scheduled retirement of a debt instrument, the holder generally is treated as receiving the projected amount of any contingent payment due at maturity. In the case of a sale, exchange or unscheduled retirement of a debt instrument, general recognition principles of tax law generally apply (e.g., section 1001(b)). However, the amount realized by a holder on either the scheduled retirement, or the sale, exchange, or unscheduled retirement of a debt instrument, is reduced by any negative adjustment carryforward existing in the taxable year of the sale, exchange or retirement.

To calculate gain or loss other than foreign currency gain or loss, the proposed regulations require the translation of the amount realized into functional currency. Foreign currency gain or loss is computed separately, as described below. The proposed regulations generally translate the amount realized by reference to the rates used to translate the components

of interest and principal that make up adjusted basis. The amount realized is translated using the adjusted basis rates in order to separate from the foreign currency gain or loss the amount of gain or loss on the sale, exchange or retirement of the debt instrument which does not result from changes in foreign exchange rates. Thus, where the amount realized in the denomination currency equals the adjusted basis of the instrument in the denomination currency prior to translation, the amount realized is translated in its entirety by reference to the rates used to translate adjusted basis. Where the amount realized differs from the adjusted basis prior to translation, additional attribution and translation rules are required.

Where the amount realized in the denomination currency is less than the adjusted basis in the denomination currency, that is, where the holder realizes a loss (not taking into account foreign currency gain or loss), the following rules apply as to which parts of adjusted basis are not recovered. In the case of a scheduled retirement at maturity, the loss is attributable to principal (the amount in denomination currency which the holder paid to purchase the debt instrument). The loss is attributable to principal because the holder will not entirely recover the holder's original investment in the debt instrument. In the case of a sale or exchange, the loss is first attributable to accrued interest. Attributing the loss first to interest results in symmetrical treatment between a loss resulting from a negative adjustment and a loss resulting from a sale.

When the holder's amount realized in the denomination currency exceeds the amount of its basis in the denomination currency prior to translation, that is, where the holder realizes a gain (not taking into account foreign currency gain or loss), the excess of amount realized over adjusted basis is translated at the spot rate on the date of receipt. This rule ensures symmetrical treatment between a positive adjustment and a gain on the instrument.

Determination of Foreign Currency Gain or Loss

The proposed regulations provide that foreign currency gain or loss is determined on an instrument with respect to principal and interest based on the comparable yield and projected payment schedule under the principles of §1.988-2(b). In general, no foreign currency gain or loss is recognized until payment is made or received pursuant to the instrument, and no foreign currency gain or loss is computed with respect to positive or negative adjustments. However, foreign currency gain or loss is determined with respect to positive adjustments described in §1.1275-4(b)(9)(ii) (relating to certain fixed but deferred contingent payments), based upon the difference between the spot rate on the date the positive adjustment becomes fixed and the spot rate on the date the positive adjustment is paid or received.

Source Rules

Consistent with the rules of §1.1275-4(b)(6)(ii), the proposed regulations provide that all gain (other than foreign currency gain) on an instrument is characterized as interest for all tax purposes, including source and character rules. Losses of a holder from a contingent payment debt instrument are generally sourced by reference to the rules of §1.1275-4(b)(9)(iv). Under §1.1275-4(b)(9)(iv), a holder's deductions or loss related to a contingent payment debt instrument that are treated as ordinary losses are treated as deductions that are definitely related to the class of gross income to which income from such debt instrument belongs. Deductions or losses that the holder treats as capital losses are allocated, consistently with the general principles of §1.865-1(b)(2), to the class of gross income with respect to which interest income from the instrument would give rise.

Treatment of Subsequent Holders

The proposed regulations provide that the rules of §1.1275-4(b)(9) generally apply to subsequent holders of an instrument who purchase the instrument for an amount greater or less than the instrument's adjusted issue price (determined in the denomination currency). Accordingly, to the extent that the purchase price for an instrument exceeds the adjusted issue price of the instrument, the holder is required to allocate such excess to interest accrued on the instrument or to projected payments on the instrument in a reasonable manner. Each such allocation is treated as a negative adjustment on the instrument, and the holder's basis on the instrument is decreased as these negative adjustments are taken into account.

To the extent that the adjusted issue price of the instrument exceeds its purchase price, the holder is required to allocate such excess to interest accrued on the instrument or to projected payments on the instrument in a reasonable manner. As the difference is taken into account, the holder is treated as receiving a positive adjustment on the instrument, and the holder's basis is increased as these positive adjustments are taken into account.

The proposed regulations generally translate the difference between the purchase price and adjusted issue price into functional currency at the rate used to translate the interest or projected payment subject to the adjustment. Thus, for example, a positive adjustment attributable to interest is translated at the same rate used to translate interest in the period in which it accrues (e.g., the average rate for the accrual period). The basis adjustment corresponding to such a positive or negative adjustment is translated at the same rate applicable to the positive or negative adjustment itself.

Netting

The proposed regulations do not provide for the netting of market gain or loss with

currency gain or loss on nonfunctional currency contingent payment debt instruments. On the one hand, different character and source rules generally apply to market gain or loss and currency gain or loss, and netting such items may produce results inconsistent with the tax treatment of other types of instruments. On the other hand, where market gain or loss and currency gain or loss counteract each other with respect to a taxpayer, requiring separate recognition of such gain and loss may not accurately reflect the economic benefits and burdens associated with the instrument. Accordingly, Treasury and the IRS request comments regarding the extent to which netting should be permitted or required. Examples 2 and 4 of the proposed regulations demonstrate cases in which netting potentially could be permitted or required because both illustrate instances in which market loss could be netted against currency gain.

Debt Instruments Denominated in Multiple Currencies

In the case of an instrument for which payments are denominated in, or determined by reference to, more than one currency, the proposed regulations provide that the issuer must first determine the instrument's predominant currency, which will be used as the instrument's denomination currency for purposes of applying the rules of the proposed regulations. The predominant currency of the instrument is determined on the issue date by comparing the present value in functional currency of the noncontingent and projected payments denominated in, or determined by reference to, each currency. For this purpose, the applicable discount rate must be a nonfunctional currency discount rate, but the rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance.

After the denomination currency has been determined, all payments on the instrument that are denominated in, or determined by reference to, a currency other than the denomination currency are treated as non-currency related contingent payments for purposes of applying the rules of the proposed regulations. Treasury and the IRS request comments regarding whether all gain or loss with respect to a debt instrument for which payments are denominated in, or determined by reference to, more than one currency and which has no non-currency contingencies should be treated as foreign currency gain or loss.

Debt Instruments Issued for Non-publicly Traded Property

In the case of a nonfunctional currency contingent debt instrument issued for non-publicly traded property, the instrument is not accounted for using the noncontingent bond method. Rather, the debt instrument is separated into its components based on the currency in which the payments are denominated and whether the payments are contingent or noncontingent. The noncontingent components in each currency are treated as a separate debt instrument denominated in the currency in which the payment (or payments) is denominated. A component consisting of a contingent payment is generally treated in the manner provided in §1.1275-4(c)(4). For purposes of the contingent payment, the test rate (the interest rate which is used to discount the contingent payment so as to determine the amount of the payment which is treated as principal, and the amount which is treated as interest) is determined by reference to the dollar unless the dollar does not reasonably reflect the economic substance of the contingent component.

Proposed Effective Dates

Section 1.988-6 is proposed to apply to nonfunctional currency contingent payment debt

instruments issued 60 days or more after the date §1.988-6 is published as a final regulation in the **Federal Register**.

Special Analysis

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 these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few, if any, small entities issue or hold foreign currency denominated contingent payment debt instruments. Generally, it is expected that the only domestic holders of these instruments will likely be financial institutions, investment banking firms, investment funds, and other sophisticated investors, due to the foreign currency risk and other contingencies inherent in these instruments. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will

be available for public inspection and copying.

A public hearing has been scheduled for December 3, 2003, at 10 a.m. in room 6718 Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. 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 electronic or 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 November 12, 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 author of these regulations is Milton Cahn of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Section 1.988-1(a)(3), (4) and (5) as proposed on March 17, 1992 at 57 FR 9218 income tax regulations are withdrawn, and 26 CFR part 1 is proposed to be amended as follows:

Part 1--INCOME TAXES

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

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

Par. 2. Section 1.988-2 is amended by:

1. Adding the text of paragraph (b)(2)(i)(B)(1).

2. Removing the last sentence of paragraph (b)(2)(i)(B)(2).

The addition reads as follows:

§1.988-2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) * * * (1) Operative rules. See §1.988-6 for rules applicable to contingent debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

* * * * *

Par. 3. Section 1.988-6 is added to read as follows:

§1.988-6 Nonfunctional currency contingent payment debt instruments.

(a) In general--(1) Scope. This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment

debt instruments described in this paragraph (a)(1). Except as set forth by the rule in this section, the rules in §1.1275-4 (relating to contingent payment debt instruments) apply to the following instruments--

(i) A debt instrument described in §1.1275-4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275-4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275-4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in §1.1275-4(c)(1) rather than §1.1275-4(b)(1) (e.g., the instrument is issued for non-publicly traded property).

(2) Exception for hyperinflationary currencies--(i) In general. Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in §1.985-1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument's economic substance.

(ii) Discretion as to method. If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument's economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of §1.988-2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) Instruments described in paragraph (a)(1)(i) of this section--(1) In general. Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in §1.1275-4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph (b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer's functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument. Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described

in paragraph (a)(1)(iv) of this section.

(2) Application of noncontingent bond method--(i) Accrued interest. Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in the denomination currency of the instrument by applying the noncontingent bond method, set forth in §1.1275-4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in §1.1275-4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in §1.1275-4(b)(4)(i) shall be the rate described in §1.1274-4(d) with respect to the denomination currency.

(ii) Net positive and negative adjustments. Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275-4(b)(6) (and §1.1275-4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in the denomination currency, the excess is treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder's total interest inclusions on the debt instrument (determined

in the denomination currency) exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer's total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year's interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of §1.1275-4(b)(6)(iii)(C), in the denomination currency.

(iii) Adjusted issue price. The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275-4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument's issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) Adjusted basis. The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275-4(b)(7) in the taxpayer's functional currency. In accordance with those rules, a holder's basis in the debt instrument is increased by

the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) Amount realized. The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275-4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) Treatment and translation of amounts determined under noncontingent bond method--(i) Accrued interest. The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer's functional currency at the average exchange rate, as described in §1.988-2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in §1.988-2(b)(2)(iii)(B).

(ii) Net positive and negative adjustments--(A) Net positive adjustments. A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the taxpayer's functional currency at the spot rate on the last day of the taxable year in which the adjustment is

taken into account under §1.1275-4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) Net negative adjustments. A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer's functional currency under the following rules:

(1) The amount of a net negative adjustment determined in the denomination currency that reduces the current year's interest in that currency shall first reduce the current year's accrued but unpaid interest, and then shall reduce the current year's interest which was accrued and paid. No translation is required.

(2) The amount of a net negative adjustment treated as ordinary income or loss under §1.1275-4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(3) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(1) and (2) of this section is attributable to interest accrued and paid in prior taxable years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(4) Any amount of the net negative adjustment remaining after application of paragraphs

(b)(3)(ii)(B)(1), (2) and (3) of this section is a negative adjustment carryforward, within the meaning of §1.1275-4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to interest reduces the holder's amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in §1.1275-4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) Adjusted basis--(A) In general. Except as otherwise provided in this paragraph and paragraphs (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under §1.1275-4(b)(7)(iii) into functional currency as follows:

(1) The holder's initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(2) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(3) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder's basis in the instrument under §1.1275-4(b)(7)(iii) are translated as follows:

(i) The payment first is attributable to the most recently accrued interest to which prior

amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(ii) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(3)(i) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) Exception for interest reduced by a negative adjustment carryforward. Solely for purposes of this §1.988-6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) Amount realized--(A) Instrument held to maturity--(1) In general. With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer's holding period as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(2) Subsequent purchases at discount and fixed but deferred contingent payments. For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to

adjusted basis under paragraph (b)(7) or (8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) Sale, exchange, or unscheduled retirement--(1) Holder. In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder's amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (i.e., any excess of the sale price over the holder's basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(2) Issuer. In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) Effect of negative adjustment carryforward with respect to the issuer. Any amount of negative adjustment carryforward treated as ordinary income under §1.1275-4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) Determination of gain or loss not attributable to foreign currency. A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in §1.1275-4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) Determination of foreign currency gain or loss--(i) In general. Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of §1.988-2(b).

(ii) Foreign currency gain or loss attributable to accrued interest. The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount the amount

determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) Principal. The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the holder, if later, acquired. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) Payment ordering rules--(A) In general. Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(1) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(2) Any amount remaining after applying paragraph (b)(5)(iv)(A)(1) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts

have not already been attributed to such period.

(3) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(1) and (2) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) Special rule for sale or exchange or unscheduled retirement. Payments made or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest. A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) Source of gain or loss. The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.988-4. Consistent with the rules of §1.1275-4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.1275-4(b)(9)(iv). The source of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.865-1(b)(2).

(7) Basis different from adjusted issue price--(i) In general. The rules of §1.1275-4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument's adjusted issue price.

(ii) Determination of basis. If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder's initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) Purchase price greater than adjusted issue price. If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275-4(b)(9)(i)(B), reasonably allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) Purchase price less than adjusted issue price. If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275-4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) Fixed but deferred contingent payments. In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of §1.1275-4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under §1.1275-4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) Examples. The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

Example 1. Treatment of net positive adjustment--(i) Facts. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and §1.1275-4(b), is 10 percent, compounded annually, and the projected payment schedule, as constructed under the rules of §1.1275-4(b), provides for a single payment of £1210 on December 31, 2006 (consisting of a noncontingent payment of £975 and a projected payment of £235). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00=$ 1.00
Dec. 31, 2005	£1.00=$ 1.10
Dec. 31, 2006	£1.00=$ 1.20

Accrual period	Average rate (pounds to dollars)
2005	£1.00=$ 1.05
2006	£1.00=$ 1.15

(ii) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2005 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($1.05 x £100 = $105). Accordingly, Z has interest income in 2005 of $105.

(B) Adjusted issue price and basis. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is $1105.

(iii) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £110 of interest on the debt instrument for 2006 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £110 at the average exchange rate for the accrual period ($1.15 x £110 = $126.50). Accordingly, Z has interest income in 2006 of $126.50.

(B) Effect of net positive adjustment. The payment actually made on December 31, 2006, is £1300, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of £90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the £90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on the last day of the year ($1.20 x £90 = $108). Accordingly, Z has a net positive adjustment of $108 resulting in a total interest inclusion for 2006 of $234.50 ($126.50 + $108 = $234.50).

(C) Adjusted issue price and basis. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) Amount realized. Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1210 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £1000 of the £1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Z's total amount realized is $1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) Foreign currency gain or loss. Under paragraph (b)(5) of this section Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), £1210. The amount of recognized foreign currency gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is $15 [£100 x ($1.20 - $1.05)]. With respect to interest accrued in 2006, the foreign currency gain equals $5.50 [£110 x ($1.20 - $1.15)]. With respect to principal, the foreign currency gain is $200 [£1000 x ($1.20 - $1.00)]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $220.50.

(F) Source. Z has interest income of $105 in 2005, interest income of $234.50 in 2006 (attributable to £110 of accrued interest and the £90 net positive adjustment), and a foreign currency gain of $220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 2. Treatment of net negative adjustment--(i) Facts. Assume the same facts as in Example 1, except that Z receives £975 at maturity instead of £1300.

(ii) Treatment in 2005. The treatment of the debt instrument in 2005 is the same as in Example 1. Thus, Z has interest income in 2005 of $105. On January 1, 2006, the adjusted issue price of the debt instrument is £1100, and Z's adjusted basis in the instrument is $1105.

(iii) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is £110 (adjusted

issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($1.15 x £110 = $126.50).

(B) Effect of net negative adjustment. The payment actually made on December 31, 2006, is £975, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(1) of this section the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.05). Accordingly, Z has an ordinary loss of $105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) Adjusted issue price and basis. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) Amount realized. Even though Z receives £975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated as receiving £1185 (£1210 - £25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £975 of the £1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $975. Z's amount realized is $1206.50 ($105 +$126.50 + $975 = $1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $25 on retirement of the instrument ($1206.50 - $1231.50 = -$25).

(E) Foreign currency gain or loss. Z recognizes foreign currency gain with respect to the consideration actually received at maturity, £975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the

ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $195 [£975 x ($1.20 - $1.00)].

(F) Source. In 2006, Z has an ordinary loss of $105, a capital loss of $25, and a foreign currency gain of $195. Under paragraph (b)(6) of this section and §1.1275-4(b)(9)(iv), the $105 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865-1(b)(2), the $25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $195 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 3. Negative adjustment and periodic interest payments--(i) Facts. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00=$ 1.00
June 30, 2005	£1.00=$ 1.20
Dec. 31, 2005	£1.00=$ 1.40
June 30, 2006	£1.00=$ 1.60
Dec. 31, 2006	£1.00=$ 1.80

Accrual period	Average rate (pounds to dollars)

Jan. - June 2005	£1.00=$ 1.10
July - Dec. 2005	£1.00=$ 1.30
Jan. - June 2006	£1.00=$ 1.50
July - Dec. 2006	£1.00=$ 1.70

(ii) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £50 of interest on the debt instrument for the January-June accrual period (issue price of £1000 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £50 at the average exchange rate for the accrual period ($1.10 x £50 = $55.00). Similarly, Z accrues £51 of interest in the July-December accrual period [(£1000 + £50 - £30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.30 x £51 = $66.30). Accordingly, Z accrues $121.30 of interest income in 2005.

(B) Adjusted issue price and basis--(1) January-June accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is £1020 (£1000 + £50 - £30 = £1020). For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.10 x £50 = $55). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest ($1.10 x £30 = $33). Accordingly, Z's adjusted basis as of July 1, 2005, is $1022 ($1000 + $55 - $33).

(2) July-December accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is £1041 (£1020 + £51 - £30 = £1041). For purposes of determining Z's dollar basis in the debt instrument, the $1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.30 x £51 = $66.30). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest ($1.30 x £30 = $39). Accordingly, Z's adjusted basis as of January 1, 2006, is $1049.30 ($1022 + $66.30 - $39).

(C) Foreign currency gain or loss. Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot rate on the date the £30 payment was made and the average exchange

rate for the accrual period during which the interest accrued. Accordingly, Z recognizes $3 of foreign currency gain on the January-June interest payment [£30 x ($1.20 - $1.10)], and $3 of foreign currency gain on the July-December interest payment [£30 x ($1.40 - $1.30)]. Z recognizes in 2005 a total of $6 of foreign currency gain.

(D) Source. Z has interest income of $121.30 and a foreign currency gain of $6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is £52.05 (adjusted issue price of £1041 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £52.05 at the average exchange rate for the accrual period ($1.50 x £52.05 = $78.08). Similarly, Z accrues £53.15 of interest in the July-December accrual period [(£1041 + £52.05 - £30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.70 x £53.15 = $90.35). Accordingly, Z accrues £105.20, or $168.43, of interest income in 2006.

(B) Effect of net negative adjustment. The payment actually made on December 31, 2006, is £981.00, rather than the projected £1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of £105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) Adjusted issue price and basis--(1) January-June accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2006, the adjusted issue price of the debt instrument is £1063.05 (£1041 + £52.05 - £30 = £1063.05). For purposes of determining Z's dollar basis in the debt instrument, the $1049.30 adjusted basis is increased by the £52.05 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.50 x £52.05 = $78.08). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest ($1.50 x £30 = $45). Accordingly, Z's adjusted basis as of July 1, 2006, is $1082.38 ($1049.30 + $78.08 - $45).

(2) July-December accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31,

2006, the adjusted issue price of the instrument is £1086.20 (£1063.05 + £53.15 - £30 = £1086.20). For purposes of determining Z's dollar basis in the debt instrument, the $1082.38 adjusted basis is increased by the £53.15 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.70 x £53.15 = $90.36). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest ($1.70 x £30 = $51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is $1121.74 ($1082.38 + $90.36 - $51).

(D) Amount realized. Even though Z receives £981.00 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1086.20 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £20 of the £1086.20 (representing the interest accrued in the January-June 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.10), resulting in an amount realized of $22; £21 of the £1086.20 (representing the interest accrued in the July-December 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.30), resulting in an amount realized of $27.30; £22.05 of the £1086.20 (representing the interest accrued in the January-June 2006 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $33.08; £23.15 of the £1086.20 (representing the interest accrued in the July 1-December 31, 2006 accrual period, less the £30 interest payment) is translated into dollars at the rate at which it was accrued (£1 = $1.70), resulting in an amount realized of $39.36; and £1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Accordingly, Z's total amount realized is $1121.74 ($22 + $27.30 + $33.08 + $39.36 + $1000), the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) Foreign currency gain or loss. Z recognizes foreign currency gain with respect to each £30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(3) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $18 of foreign currency gain on the January-June 2006 interest payment [£30 x ($1.60 - $1.00)], and $24 of foreign currency gain on the July-December 2006 interest payment [£30 x ($1.80 - $1.00)]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, £981.00. The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With

respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the £30 payments), the foreign currency gain is $14 [£20 x ($1.80 - $1.10)]. With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the £30 payments), the foreign currency gain is $10.50 [£21 x ($1.80 - $1.30)]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is $752 [£940 x ($1.80 - $1.00)]. Thus, Z recognizes a foreign currency gain of $42 on receipt of the two £30 payments in 2006, and $776.50 ($14 + $10.50 + $752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of $818.50.

(F) Source. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 4. Purchase price greater than adjusted issue price--(i) Facts. On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§1.988-2(b)(2) and 1.1275-4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of §1.1275-4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
July 1, 2005	£1.00=$ 1.00
Dec. 31, 2006	£1.00=$ 2.00

Accrual period	Average rate (pounds to dollars)

July 1 - December 31, 2005	£1.00=$ 1.50
January 1 - June 30, 2006	£1.00=$ 1.50
July 1 - December 31, 2006	£1.00=$ 1.50

(ii) Initial basis. Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is $1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (£1 = $1).

(iii) Allocation of purchase price differential. Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of £1161.76 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ($1.50 x £59.54 = $89.31). Accordingly, Z has interest income in 2005 of $89.31.

(B) Adjusted issue price and basis. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1221.30 (£1161.76 + £59.54). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the $1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is $1494.31 [$1405 + (£59.54 x $1.50)].

(v) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of £1221.30 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ($1.50 x £62.59 = $93.89). Similarly, Z accrues £65.80 of interest in the July-December 2006 accrual period [(£1221.30 + £62.59) x 10.25 percent/2], which is translated at the average exchange rate for the accrual period ($1.50 x £65.80 = $98.70). Accordingly, Z accrues £128.39, or $192.59, of interest income in 2006.

(B) Effect of positive and negative adjustments--(1) Offset of positive adjustment. The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of

the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 (£50.30 - £243.24 = -£192.94) for 2006.

(2) Offset of accrued interest. Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.50). Accordingly, Z has an ordinary loss of $89.31 in 2006. The remaining £5 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) Adjusted issue price and basis--(1) January-June accrual period. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89 (£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is $1588.20 ($1494.31 + $93.89).

(2) July-December accrual period. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued interest for July-December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1686.90 ($1588.20 plus $98.70 of accrued interest for July-December).

(3) Adjustment to basis upon contingent payment. Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = $1). Accordingly, Z's adjusted basis in the debt instrument at maturity is $1443.66 ($1686.90 - $243.24).

(D) Amount realized. Even though Z receives £1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 - £5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $89.31; £62.59 of the £1344.69 (representing the interest accrued in January-June 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $93.89; £65.80 of the

£1344.69 (representing the interest accrued in July-December 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $98.70; and £1156.76 of the £1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1156.76. Z's amount realized is $1438.66 ($89.31 + $93.89 + $98.70 + $1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $5 on retirement of the instrument ($1438.66 - $1443.66 = -$5).

(E) Foreign currency gain or loss. Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of $1400 [£1400 x ($2.00 - $1.00)].

(F) Source. Z has an ordinary loss of $89.31, a capital loss of $5, and a foreign currency gain of $1400. Under paragraph (b)(6) of this section and §1.1275-4(b)(9)(iv), the $89.31 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865-1(b)(2), the $5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $5 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 5. Sale of an instrument with a negative adjustment carryforward--(i) Facts. On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is £50. On December

30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003	£1.00=$ 1.00
Dec. 31, 2005	£1.00=$ 2.00
Dec. 30, 2006	£1.00=$ 2.00

Accrual period	Average rate (pounds to dollars)
January 1 - December 31, 2004	£1.00=$ 2.00
January 1 - December 31, 2005	£1.00=$ 2.00
January 1 - December 31, 2006	£1.00=$ 2.00

(ii) Treatment in 2004--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2004 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($2.00 x £100 = $200). Accordingly, Z has interest income in 2004 of $200.

(B) Adjusted issue price and basis. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is $1200 ($1000 + $200).

(iii) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($2.00 x £110 = $220).

(B) Effect of net negative adjustment. The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(1) of this section, the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z

treats the remaining £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $2.00). Accordingly, Z has an ordinary loss of $200 in 2005. The remaining £50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) Adjusted issue price and basis. Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006 is £900, i.e., the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $900 (determined as described below). Z's adjusted basis on January 1, 2006 is Z's adjusted basis on January 1, 2005 ($1200), increased by the functional currency amount of interest accrued in 2005 ($220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ($1200 + $220 = $1420), is decreased by $520 ($220 + $200 + $100 = $520). Z's adjusted basis on January 1, 2006 is therefore, $900.

(D) Foreign currency gain or loss. Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $50 of foreign currency gain on the £50 payment. [($2.00 - $1.00) x £50 =$50]. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2004 (adjusted issue price of £900 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ($2.00 x £90 = $180). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of $180.

(B) Effect of net negative adjustment. The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative adjustment carryforward, Z will accrue $80 of interest income. [(£90-£50) x $2.00 = $80]

(C) Adjusted issue price. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) Adjusted basis. For purposes of determining Z's dollar basis in the debt instrument, Z's $900 adjusted basis on January 1, 2006 is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, i.e., £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, i.e., £1.00 =$1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is $1030 ($900 + $50 + $80).

(E) Amount realized. Z's amount realized in denomination currency is £940, i.e., the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(1) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also is translated by reference to the principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is $940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of $90 on the sale of the debt instrument ($1030 basis - $940 amount realized). Under paragraph (b)(4) of this section and § 1.1275-4(b)(8), $80 of the loss is characterized as ordinary loss, and the remaining $10 of loss is characterized as capital loss. Under §§ 1.988-6(b)(6) and 1.1275-4(b)(9)(iv) the $80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§ 1.988-6(b)(6) and 1.865-1(b)(2) the $10 capital loss is also allocated to the interest income from the debt instrument.

(F) Foreign currency gain or loss. Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under

paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of $940. [($2.00-$1.00) x £940]. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of $940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) Multicurrency debt instruments--(1) In general.

Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) Determination of denomination currency. The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. The predominant currency of the instrument shall be determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The

predominant currency is determined as of the issue date and does not change based on subsequent events (e.g., changes in value of one or more currencies).

(3) Issuer/holder consistency. The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of §1.1275-2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) Treatment of payments in currencies other than the denomination currency. For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as non-currency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under §1.1275-4(b) rather than this section.

(e) Instruments issued for nonpublicly traded property--(1) Applicability. This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in §1.1275-4(c)(1) rather than §1.1275-4(b)(1). For example, this paragraph (e) generally applies to a contingent debt instrument denominated in a nonfunctional currency that is issued for non-

publicly traded property. Generally the rules of §1.1275-4(c) apply except as set forth by the rules of this paragraph (e).

(2) Separation into components. An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of §1.1275-4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) Treatment of components consisting of one or more noncontingent payments in the same currency. The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under §1.1274-2(c)(2), and the test rate shall be determined under §1.1274-4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273-1(c)) and the de minimis rules of section 1273(a)(3) and §1.1273-1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided in §1.988-2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) Treatment of components consisting of contingent payments--(i) General rule. A component consisting of a contingent payment shall generally be treated in the manner provided

in §1.1275-4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test rate shall be determined by reference to the currency which most reasonably reflects the economic substance of the contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) Certain delayed contingent payments--(A) Separate debt instrument relating to the fixed component. The rules of §1.1275-4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of §1.988-2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) Contingent component. With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under §1.1275-4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the issuer or holder at the spot rate on the date the payment becomes fixed.

(5) Basis different from adjusted issue price. The rules of §1.1275-4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) Treatment of a holder on sale, exchange, or retirement. The rules of §1.1275-4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) Rules for nonfunctional currency tax exempt obligations described in §1.1275-4(d). [RESERVED]

(g) Effective date. This section shall apply to debt instruments issued 60 days or more after the date final regulations are published in the **Federal Register**.

Par. 4. In §1.1275-4, paragraph (a)(2)(iv) is revised to read as follows:

§1.1275-4 Contingent payment debt instruments.

(a)***

(2)***

(iv) A debt instrument subject to section 988 (except as provided in §1.988-6);

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David A. Mader

Acting Deputy Commissioner of Internal Revenue.

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.
August 28, 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 $33,735 million of publicly held 13-week and 26-week Treasury bills maturing September 4, 2003, and to pay down approximately $1,735 million. Also maturing is an estimated $17,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced September 2, 2003.

The Federal Reserve System holds $14,924 million of the Treasury bills maturing on September 4, 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 September 3, 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 $1,053 million into the 13-week bill and $622 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 686

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED SEPTEMBER 4, 2003

August 28, 2003

Offering Amount	$16,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$ 5,600 million	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 5,600 million	$ 5,600 million
NLP Reporting Threshold	$ 5,600 million	$ 5,600 million
NLP Exclusion Amount	$ 6,200 million	None
Description of Offering:		
Term and type of security	91-day bill	182-day bill
CUSIP number	912795 NZ 0	912795 PN 5
Auction date	September 2, 2003	September 2, 2003
Issue date	September 4, 2003	September 4, 2003
Maturity date	December 4, 2003	March 4, 2004
Original issue date	June 5, 2003	September 4, 2003
Currently outstanding	$24,387 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.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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EMARGOED UNTIL 11:00 A.M.
August 28, 2003

CONTACT: Office of Financing
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TREASURY OFFERS CASH MANAGEMENT BILLS

The Treasury will auction approximately $23,000 million of 12-day Treasury cash management bills to be issued September 3, 2003.

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

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

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

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

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

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

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Attachment

JS 687

HIGHLIGHTS OF TREASURY OFFERING
OF 12-DAY CASH MANAGEMENT BILLS

August 28, 2003

Offering Amount ..... $23,000 million
Maximum Award (35% of Offering Amount) .. $ 8,050 million
Maximum Recognized Bid at a Single Rate . $ 8,050 million
NLP Reporting Threshold ..... $ 8,050 million

Description of Offering:
Term and type of security ..... 12-day Cash Management Bill
CUSIP number ..... 912795 QG 9
Auction date ..... September 2, 2003
Issue date ..... September 3, 2003
Maturity date ..... September 15, 2003
Original issue date ..... September 3, 2003
Currently outstanding ..... ---
Minimum bid amount and multiples ... $1,000

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

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

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