Treas.
HJ
10
.A13
P4
v.414

Department of the Treasury

PRESS RELEASES

The following numbers were not used:

JS-1493, 1562-1599, 1601-1660, 1684 and 1688

Some numbers in May and June 2004 were used twice.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 3, 2004
JS-1489

Treasury Announces Market Financing Estimates

The Treasury Department announced today that it expects net borrowing of marketable debt to total $38 billion in the April – June 2004 quarter. The projected cash balance on June 30 is $45 billion. In the last quarterly announcement on February 2, 2004, Treasury announced that it expected net borrowing to total $75 billion with an end-of-quarter cash balance of $45 billion. The decrease in borrowing is due to higher receipts, both from lower refunds and higher payroll and individual taxes, lower outlays, and higher State and Local Government Series net issuances.

Treasury also announced that it expects net borrowing of marketable debt to total $91 billion in the July – September 2004 quarter. The projected cash balance on September 30 is $35 billion.

During the January – March 2004 quarter, Treasury's net marketable borrowing totaled $146 billion and the cash balance on March 31 was $21 billion. On February 2, Treasury announced that it expected net marketable borrowing to total $177 billion with an end-of-quarter cash balance of $20 billion. The decrease in borrowing is largely attributable to lower tax refunds and higher payroll taxes.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, May 5.

REPORTS

- Treasury Announces Market Financing Estimates

TREASURY ANNOUNCES MARKET FINANCING ESTIMATES

Today, the Treasury Department announced net borrowing of marketable debt for the April – June 2004 and July – September 2004 quarters.

Quarter	Estimated Borrowing ($ billion)	End-of-Quarter Cash Balance ($ billion)
Apr-Jun 2004	$38	$45
Jul-Sep 2004	$91	$35

Since 1997, the average forecast error in net market borrowing for the current quarter is $10 billion, of which $1 billion is attributable to differences in the end-of-quarter cash balance. Similarly, the average forecast error for the following quarter is $45 billion, of which $10 billion is attributable to differences in the end-of-quarter cash balance.

The following tables display and reconcile the variation between forecasted and actual net marketable borrowing in the Jan - Mar 2004 quarter.

Quarter	Estimated Borrowing ($ billions)	Actual Borrowing ($ billions)	Estimated End-of-Quarter Cash Balance ($ billions)	Actual End-of-Quarter Cash Balance ($ billions)
Jan - Mar 2004	$177	$146	$20	$21

-more-

Categories	Chg from Feb Estimate
Receipts	+$30**
Outlays	+$4
Non-Marketable Activity	-$2
Change in Cash Balance	-$1

** includes tax refunds

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, May 5.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 5, 2004
JS-1490

Deputy Assistant Secretary for Federal Finance Timothy S. Bitsberger May 2004 Quarterly Refunding Statement

Treasury is announcing the following changes to the issuance calendar:

- A new 5-year TIPS with the first auction in October 2004;

- A new 20-year TIPS with the first auction in July 2004.

Treasury is also considering canceling the regular reopening of nominal 10-year securities. We will provide one quarter notice before any change.

Details of the May Refunding

We are offering $54.0 billion of notes to refund approximately $32.8 billion of privately held securities and Government account holdings maturing or called on May 15, raising approximately $21.2 billion. The securities are:

- A new 3-year note in the amount of $24 billion, maturing May 15, 2007;

- A new 5-year note in the amount of $15 billion, maturing May 15, 2009;

- A new 10-year note in the amount of $15 billion, maturing May 15, 2014.

These securities will be auctioned on a yield basis at 1:00 PM Eastern time on Tuesday, May 11, Wednesday, May 12, and Thursday, May 13, respectively. All of these auctions will settle on Monday, May 17. The balance of our financing requirements will be met with weekly bills, monthly 2-year and 5-year notes, the June 10-year note reopening, and the July 10-year and 20-year TIPS. Treasury is also likely to issue cash management bills in early June and July.

5-year TIPS and 20-year TIPS

Treasury is adding both a 5-year TIPS and a 20-year TIPS to its auction calendar. Each security will be auctioned semiannually. The 5-year TIPS will be auctioned on an April/October cycle and the 20-year TIPS will be on a January/July cycle. The first issues of these securities in July and October of this year will have an initial maturity a half year longer than usual and will be reopened twice. Accordingly, the 20-year TIPS issued in July 2004 will have an initial maturity of 20½-years and will be reopened in January 2005 and July 2005. Similarly, the 5-year TIPS issued in October 2004 will have an initial maturity of 5½-years and will be reopened in April 2005 and October 2005. Starting with the 20-year TIPS issued in January 2006 and the 5-year TIPS issued in April 2006, these securities will be reopened only once six months after the original issue.

TIPS Auction and Maturity Dates

The new 5-year TIPS and 20-year TIPS will be auctioned in the second half of the month and settle on the last business day of the month. However, these TIPS issues will continue to have mid-month maturity dates (*i.e.*, April 15th for the 5-year TIPS and January 15th for the 20-year TIPS). Investors who purchase these securities at auction will be required to pay Treasury the interest accrued between the 15th of the month and the settlement date. The auction schedule for 10-year TIPS is not changing; 10-year TIPS will continue to be auctioned in the first part of the month and settle on the 15th of the month.

Zero Bound on TIPS Coupons

In the event that the high accepted yield in an auction of a new TIPS issue is negative, the security will have a zero coupon, and Treasury will issue the security at a premium above the par value. Investors will receive the inflation-adjusted par amount at maturity.

Cessation of the Long Term Treasury Rate

In Treasury's February 2002 Quarterly Refunding statement, we announced that publication of a 30-year Constant Maturity Treasury (CMT) Yield was being discontinued and that a "long term yield" average based on the bid yields on all Treasury bonds with 25 or more years remaining to maturity (LT>25 average) would be published in place of the 30-year CMT. We also announced the publication of an "extrapolation factor" to allow users to calculate a proxy estimate for a 30-year yield. Because there are currently only three (3) bonds outstanding with more than 25 years to maturity, we are ceasing the publication of the LT>25 average. We will continue to publish an extrapolation factor, but as of June 1, 2004 that factor will be based on an extrapolation from the 20-year yield curve point. For further details on this, please see http://www.treas.gov/offices/domestic-finance/debt-management/interest-rate/index.html

Other Policy Issues under Consideration

Nominal 10-year Note Reopening Policy

The introduction of two new TIP securities accompanied with smaller than anticipated borrowing needs for this year and forecasts for declining deficits going forward has led Treasury to reconsider its nominal 10-year note reopening policy.

State and Local Government Securities (SLGS) Proposed Regulatory Changes

This summer Treasury will announce proposed regulatory changes for dealing with trading activities that we view are against the spirit and purpose of the SLGS program and are detrimental to efficient Treasury financing. The purpose of the SLGS program is "to assist tax-exempt issuers with complying with applicable provisions of the Internal Revenue System code that apply to tax exempt issuers". It is not, nor was it ever, intended to be a trading vehicle for tax-exempt issuers to capitalize on the inherent inefficiencies and arbitrage opportunities that are artifacts of the non-marketable SLGS program, and Treasury considers its use in such manner to be inappropriate. Treasury will consider any and all comments from market participants regarding the proposed rule, before publishing a final rule.

Six-Decimal Price Awards in Treasury Auctions

In the February 2004 Quarterly Refunding Statement, Treasury announced its intentions to compute price awards in auctions to six decimal places per hundred. This change is expected to take place in the second half of this year.

In an effort to make this transition as smooth as possible for those who purchase Treasury securities, we have made the following 6-decimal pricing calculation formulas available at http://www.publicdebt.treas.gov/of/ofcalc6decimal.htm . Institutions are encouraged to use the formulas for internal testing to determine whether or not changes to their back-office systems will be necessary. Any questions regarding this testing should be directed to BPD Office of Financing at (202) 691-3550.

Changing Limits on Non-competitive Bill Awards

The limit on non-competitive awards is $1 million for bill auctions and $5 million for coupon auctions. The non-competitive award limit on coupons auctions was raised in 1991 in an effort to increase participation in Treasury auctions and reduce ownership concentrations. Treasury is studying raising the limit of noncompetitive awards in bill auctions from $1 million to $5 million. We will announce a decision at the August refunding.

The next quarterly refunding announcement will take place on Wednesday, August 4, 2004. Please send comments and suggestions on these subjects or others relating to debt management to debt.management@do.treas.gov

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 5, 2004
JS-1491

Minutes Of The Meeting Of The Treasury Borrowing Advisory Committee Of The Bond Market Association May 4, 2004

The Committee convened in closed session at the Hay-Adams Hotel at 9:35 a.m. The following members of the Committee were not present: Richard Axilrod, James Capra, Thomas Kalaris, Joseph Rosenberg, and Thomas Marsico. Deputy Assistant Secretary for Federal Finance Timothy Bitsberger welcomed the Committee and gave them the charge.

The Committee first addressed the question in the Committee charge (attached) dealing with the introduction of 5- and 20-year TIPS securities and the impact on portfolio composition, specifically the impact on 10-year nominal issuance. Before the Committee discussed the issue, Mr. Bitsberger presented a series of eight charts (attached) showing Treasury's current and projected debt distribution. The charts indicated that net market borrowing needs are currently lower than earlier projected, that the current issuance calendar is capable of handling projected deficits, that introducing TIPS will require some reduction of nominal issuance but that auction sizes will remain relatively reasonable, and that the resulting distributions in outstanding debt, both current and projected, remain within historical norms.

A discussion ensued between several members about the role of 10-year nominal debt in the Treasury market. One member opined that given the deficit numbers and the reasons Treasury previously stated for moving to reopened 10-year notes in May 2003, that it made sense now to reduce nominal 10-year issuance, but that it was difficult to characterize the impact on liquidity of eliminating the reopened 10-year note. One member stated that 10-year notes were an important risk transference vehicle and suggested that paring back 10-year note sizes would reduce the ability to transfer risk and raise the possibility of squeezes. Other members stated that issuing expensive longer-term debt just for liquidity reasons was not sufficient justification for keeping the 10-year note at current sizes; that Treasury's primary goal is and should be lowest cost of financing over time. Others, concerned about liquidity and citing the current and projected debt distribution charts, suggested that Treasury scale back nominal 10-years slightly and nominal 5-year notes more, to accommodate the new TIPS.

The discussion turned to Treasury's rollover risk. Some members noted that more than half of Treasury's debt matures within 2 years and that 63 percent matures within 3 years. This led some Committee members to suggest that while Treasury may view substituting 5- and 20-year TIPS for 10-year nominal issuance as a symmetric substitution, such a substitution actually changes the risk characteristics of Treasury's portfolio. Specifically, TIPS have a floating-rate component (the inflation component) that effectively makes them behave like a much shorter instrument. Members argued that because of the floating-rate component issuing more TIPS while cutting back long-term nominal issuance would effectively result in even more debt rolling over sooner. Committee members questioned the wisdom of this move to effectively shorten average maturity of the portfolio by substitution of TIPS issuance for long-term nominal issuance at what may be perceived as the end of a 20-year deflationary trend. Treasury officials pointed out that historical 40-year interest cost modeling, using short-dated and long-dated financing assumptions, indicate that shorter-dated issuance saves interest costs over time. Additionally, theoretical arguments concerning term-risk premiums on nominal securities argue for more TIPS issuance at the expense of long-term nominal issuance. Finally, Treasury benefits slightly from rising inflation because inflation impacts revenues sooner than outlays; Treasury should monetize the inflation by being a net seller of inflation.

The discussion next turned to initial auction sizes for new TIPS and the appropriate place for the new TIPS issues in the current calendar. Several members discussed the merits of offering 5-year TIPS, questioning the sources of demand for a 5-year instrument, noting that 5-year TIPS were once offered and discontinued. Treasury officials pointed out that in the past, the Committee was nearly evenly divided between new issuance of short and long-dated TIPS. Treasury officials pointed out that trading volume has picked up for shorter-dated TIPS in recent months and that central banks and term-restricted accounts were likely sources of decent demand. One member observed that central bank demand could decline as the dollar strengthened.

A few members pointed out that one reason trading volume on shorter-dated TIPS has increased is due to the nature of the cash flows on short-dated TIPS; short-dated TIPS trade much more like nominal 5-years notes, but allow investors to speculate on inflation expectations; because the cash flows on 5-year TIPS are similar to 5-year nominal they are not really a "new asset class". The trading volume is largely coming from speculators that traditionally hold nominal instruments, as opposed to typical buy-and-hold accounts that hold longer-dated TIPS. Members felt that introducing a 5-year TIPS would effectively be increasing 5-year nominal supply and 5-year nominal supply was already more than sufficient. More importantly, Treasury would not be attracting a new type of investor by offering a 5-year TIPS, where as the 20-year TIPS would attract new investors. One member pointed out that because 5-year TIPS trade like nominals, dealers would be more inclined to underwrite them because they are easier to hedge.

The Committee generally felt that the market wanted a 20-year TIPS and that the size should initially be about $16 to $20 billion per year, via an initial auction and a smaller reopening. The auction cycle should be such that the new instrument's cash flows are fungible with existing TIPS. The Committee's consensus was that the Treasury should wait to see if a 5-year TIPS is really needed or wanted. In the interim, seasoned 10-year TIPS could satisfy the market demand for shorter-dated TIPS. If Treasury insisted on doing a 5-year TIPS, it should be in the $16 to $20 billion per year range.

The Committee next addressed the question in the charge dealing with fiscal uncertainty and interest rate volatility. Mr. Bitsberger presented charts (attached) that depicted the budget uncertainty related to technical factors associated with the budget-modeling process. This was a continuation of sensitivity analysis presented in two prior meetings where Treasury presented charts showing the budget uncertainty associated with economic forecasts and legislation. The error terms associated with technical factors were significant and further highlighted the need for flexibility and the importance of the bill market for addressing this uncertainty. Several Committee members noted that the bill market and the short-coupon market could handle greater issuance volume with little or no concession. Others suggested that if borrowing needs were substantial and surprising, that Treasury should consider issuing at various liquid points on the curve and then swap that debt in the swap market.

The Committee then focused on the appropriate level of Treasury tolerance for interest rate volatility. One member pointed out that before Treasury can attempt to optimize a portfolio, Treasury needs to state its goal and that the Committee would like more guidance in that regard. Another member raised the issue that if there is significant correlation between deficit volatility and interest-rate volatility, that Treasury should be much more concerned about rollover risk. This member pointed out that recently there has not been significant correlation between deficit volatility and interest-rate volatility, but that this current phenomena might be extreme, i. e. , out in the "statistical tail" of past experience. Interest-rate volatility is extremely low right now but market consensus suggests that we are likely at the end of a secular deflationary trend and when cyclical themes begin to reassert themselves, interest-rate volatility could become more of a concern for Treasury.

Another member suggested that a multi-factor asset-liability framework might be needed to properly assess this question. It was difficult to make any assertions about interest-rate volatility absent knowledge of what is occurring to other Treasury assets and liabilities. Members agreed that more time be devoted to the study of this complex question, and that it be discussed further at future meetings.

The Committee then discussed the third question on the charge dealing with the November refunding calendar and auction schedule, which is complicated by several potential market-moving events and a holiday. Mr. Bitsberger presented three options for the refunding auction schedule in November. It was the consensus of the Committee that the third option presented was the best. That option has the 3-year note auction taking place on Monday, November 8; the 5-year note auction on Tuesday, November 9; and the 10-year note auction on Wednesday, November 10, after the FOMC meeting. The Committee felt that auctioning on three consecutive days was important and that volatility around auction time would be lower after the FOMC meeting. The Committee finalized its recommendation for borrowing in this quarter and the July-September quarter. Those charts are attached.

The meeting adjourned at 11:30 p.m.

The Committee reconvened at 3:30 p.m. to present the Treasury with observations on the degree of accuracy U.S labor market data. David Greenlaw of Morgan Stanley provided a presentation on the major indicators of the labor markets, namely the monthly household survey and payroll survey. He started off by pointing out that the two indicators differ in many respects, and that adjustments are necessary before the two numbers can be compared. For the time period from 1994 to 2004, the two adjusted series are close in levels but differ in changes, especially month-to-month changes. He then went on to account for the sources of the differences in the two adjusted series. First, numbers from the household surveys may be biased downward, especially lately, because of measurement errors in population, most likely due to immigration. Second, numbers from the household survey decelerate (accelerate) faster than numbers from the payroll survey around cyclical turning-point. The reason is it takes time to obtain responses from start-up and close down firms. He pointed out that quarterly data such as employment insurance taxes, census of employment and wages, withheld income and payroll taxes could be used as a benchmark revision to the survey data. Overall, in conjunction with other labor indicators such as productivity growth, Greenlaw concluded that it is likely that the employment reports are a fair indicator of employment conditions.

The meeting adjourned at 4:15 p.m.

The Committee reconvened at the Hay-Adams Hotel at 5:35 p.m. The following members of the Committee were not present: Richard Axilrod, James Capra, Thomas Kalaris, Joseph Rosenberg and Thomas Marsico. The Chairman presented the Committee report to the Under Secretary for Domestic Finance, Brian Roseboro and Deputy Assistant Secretary for Federal Finance, Tim Bitsberger. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 5:50 p.m.

Jeff Huther
Director
Office of Debt Management
May 4, 2004

Certified by:

Mark B. Werner, Chairman
Treasury Borrowing Advisory Committee
of The Bond Market Association
May 4, 2004

Treasury Borrowing Advisory Committee
Quarterly Meeting
Committee Charge - May 2004

Portfolio Composition

We are introducing both 5-year and 20-year TIPS. We will need to reduce nominal issuance to make room for additional TIPS issuance. In the absence of liquidity concerns, we would eliminate the reopenings of 10-year nominal securities to accommodate the new securities. We would like the Committee's views on eliminating the 10-year reopening, simply reducing the sizes of 10-year auctions, or spreading the reduction in issuance across both 5-year and 10-year issuance. In discussing these options, we would like the Committee's views on the timing of implementation of the Committee's preferred option. We would also like the Committee's view on initial auction sizes for these new TIPS offerings and the appropriate position for these securities in the issuance calendar.

Fiscal Uncertainty and Interest-Rate Volatility

As a follow up to discussions regarding the uncertainty of the budget-modeling process, we will show the Committee some charts illustrating the financing risk due to technical errors in budget forecasting. We will also show the Committee charts illustrating the trade-offs between interest costs and expected volatility. We would like the Committee's views on Treasury's tolerance for interest rate volatility.

Changes to Auction Calendar

The November refunding calendar is complicated by several potential market-moving events and Veterans Day. We would like the Committee's advice on the scheduling of auctions in the final quarter of this year.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $32.8 billion of privately held notes and bonds maturing or called on May 15.
- The composition of Treasury marketable financing for the remainder of the April– June quarter, including cash management bills.
- The composition of Treasury marketable financing for the July – September quarter.

Other Issues

Are there other issues relating to the current state of the Treasury market that the Committee would like to bring to Treasury's attention?

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 5, 2004
JS-1492

Report To The Secretary Of The Treasury From The

Treasury Borrowing Advisory Committee Of The Bond Market Association May 4, 2004

Dear Mr. Secretary:

Since the Committee's last meeting in February, the economy has continued to grow at a robust pace. GDP expanded at a 4.2% pace in Q1. Moreover, the latest economic readings point to a continuation of strong growth going forward. The ISM manufacturing report has continued to run at levels near the 20-year high reached in January. The latest data indicate robust home sales in March. Consumer spending grew almost 4% in Q1 despite higher energy prices and lower-than-expected tax refunds. The trend in payroll employment has strengthened, with job gains averaging 171,000 per month in Q1. The stronger trend in payrolls is consistent with the message from other employment indicators such as jobless claims.

Core inflation moved up in Q1. The core CPI rose an annualized 1.8% and the core PCE deflator was up 2.0%, bringing the year-over-year changes in March to 1.6% and 1.4%, respectively.

After maintaining its range even as most economic data pointed to a robust recovery, the Treasury market reacted sharply to news that payrolls are starting to pick up. Over the quarter, 10-year yields have risen by almost 40bp and 2s/30s curve has flattened about 15bp. Yields are currently 80bp higher than the lows observed in mid-March and the yield curve is 30bp flatter than its steepest levels of the quarter. The market is currently pricing in approximately 45% probability that the Fed will raise rates by 25bp at the June FOMC meeting and is pricing in almost 90bp of tightening by year end.

First quarter reported earnings have been strong: with 82% of the S&P 500 reporting, approximately 76% have beaten expectations while only 13% have failed to meet expectations. Despite strong corporate earnings, however, equity markets have declined over the past three months: the S&P 500 Index has fallen approximately 1% and the NASDAQ composite has fallen approximately 6%.

Driven by continued strong economic news and increased expectations of Fed tightening, the dollar has reversed its downward course over the quarter and strengthened almost 5% versus the Euro and approximately 4.5% versus the Yen.

Budget performance has been stronger than expected, with tax refunds only 8.6% higher than last year compared to Treasury's prior expectations of close to a 20% increase. At this point in the filing season, approximately 95% of non-withheld tax payments have usually been received, and they are running about 5% lower than last year.

Against this economic and financial backdrop, the members of the Committee began consideration of debt management questions included in the Quarterly Charge. Following their standard format, Treasury presented a chart package that will be released as part of the Treasury refunding announcement.

In its Charge to the Committee, Treasury stated that it will introduce 5-year and 20-year TIPS and that it will continue to increase TIPS issuance nominally and as a percentage of total debt outstanding. Treasury asked the Committee's advice as to where investor demand for TIPS would be greatest and in which sectors it would recommend reducing issuance.

Members of the Committee were uniform in their support for a new 20-year TIP Most members felt strong investor demand would be manifest in this sector. Members had differing opinions as to investor preference for 5-year TIPS with most expressing reservations about large-scale issuance. As to the question of which nominal issues to reduce in order to facilitate increased TIPS issuance, most members expressed reservations about canceling the reopening of 10-year note auctions. In fact, many members were reluctant to reduce nominal 10-year note issuance too dramatically. Members favored larger reductions in 5-year nominal issuance as well as reducing 10-year nominal issuance and bills. Because TIPS cash flows differ from those of nominals, replacement of like maturity nominals with TIPS was not favored by most members. In particular, the variable nature of the inflation component of TIPS' cash flows was a factor in most members' recommendations to reduce issuance of nominals along the yield curve. Other members voiced concerns that eliminating 10-year auctions may impede the risk transference utility that Treasury securities provide to the market by substituting less liquid securities for those that are more liquid.

The Committee then responded to Treasury's second question in the Charge by considering a number of slides that demonstrated forecast volatility in the Federal budget over prior cycles. Specifically, Treasury showed a slide depicting current and future budget projections in comparison with the January 2001 CBO baseline forecast. Treasury highlighted a number of contributors to the large forecasting error namely revenues, debt service changes due to legislation, spending, technical errors and economic factors. Treasury responded to past Committee guidance to show measures of forecast confidence around the Federal budget in out years. Treasury highlighted the fact that the changes in interest expense are largely due to factors outside of the control of debt managers. Treasury then presented a slide showing three financing strategies and expressed a preference for balanced issuance along the yield curve and asked the Committee to opine as to Treasury's tolerance for interest rate volatility given the difficulty inherent in forecasting required debt issuance. Committee members expressed support for Treasury furthering its ongoing efforts to implement analytical tools that illustrate borrowing needs and expenses under a wide array of scenarios. Members felt that risk analysis which illustrates interest rate expense and nominal borrowing requirements during periods of fiscal deficit and high nominal interest rates, as well as fiscal surplus and low nominal interest rates, would be a welcome addition to Treasury's debt management process. Members also discussed adoption of a mean variance framework to debt management and concluded further study was required before a concise recommendation could be made to Treasury.

Treasury then asked the Committee to offer advice as to the scheduling of the November 2004 refunding. Three potential options were offered to the group for consideration. The consensus view was that it was necessary to be sensitive to the employment release and the FOMC meeting, while scheduling around the Veteran's Day holiday. Additionally, preserving the identity of the three-day auction schedule that draws focus and liquidity to the underwriting process would be favorable for the Treasury. The Committee recommended November 8th, 9th and 10th as the days following the November 3rd announcement to underwrite 3-year notes, 5-year notes and 10-year notes.

The Committee then addressed the question of the composition of Treasury notes to refund approximately $32.03 billion of privately held notes and bonds maturing on May 17th as well as the composition of Treasury marketable financing for the remainder of the April-June quarter, including cash management bills for the July-

September quarter. To refund $32.03 billion of privately held notes and bonds maturing May 17th, 2004, the Committee recommended a $24 billion 3-year note due 5/15/07, a $14 billion 5-year note due 5/15/09, and a $15 billion 10-year note due 5/15/14. For the remainder of the quarter, the Committee recommended a $26 billion 2-year note issued in May and a $26 billion 2-year note issued in June, a $14 billion 5-year note issued in June and $11 billion reopening of the 10-year note in June. The Committee also recommended a $20 billion 11-day cash management bill issued 6/4/04 and maturing 6/15/04. For the July-September quarter, the Committee recommended financing as contained in the attached table. Relevant features include three $26 billion monthly 2-year notes, a $24 billion 3-year note, three $14 billion monthly 5-year notes, a $15 billion 10-year note issued in August followed by a $10 billion reopening of that 10-year note in September. The Committee further recommended a $10 billion 10-year TIPS for issuance in July as well as a $10 billion 20-year TIPS for issuance in July.

Respectfully submitted,
Mark B. Werner
Chairman

Ian Banwell
Vice Chairman

REPORTS

- TBAC Recommended Financing Tables: Q2
- TBAC Recommended Financing Tables: Q3

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

April 29, 2004
js-1494

Treasury Publishes Final PFIC Mark To Market Regulations

Today, the Treasury Department published final regulations providing guidance for taxpayers that elect to mark to market stock of a passive foreign investment company. Passive foreign investment companies, or PFICs, are foreign corporations that predominantly earn, or hold assets that produce, passive or investment-type income, such as foreign mutual funds. The final regulations provide operating rules for making the mark to market election and for making determinations with respect to the annual mark to market inclusions. The final regulations also provide for the coordination of the mark to market regime with the rules that apply to PFICs generally.

The final regulations generally follow the proposed regulations, which were published in July of 2002, with some modest modifications in response to comments from taxpayers. The final regulations are effective for taxable years beginning after December 31, 2004.

The text of the final regulations is attached and will be on file tomorrow at the Federal Register.

-30-

REPORTS

- final regulations

[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9123]

RIN 1545-AY17

Electing Mark to Market for Marketable Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide procedures for certain United States persons holding marketable stock in a passive foreign investment company (PFIC) to elect mark to market treatment for that stock under section 1296 of the Internal Revenue Code and related provisions of sections 1291 and 1295. These final regulations affect United States persons owning marketable stock in a PFIC.

DATES: Effective Date: These regulations are effective May 3, 2004.

Applicability Date: For dates of applicability, see §§1.1291-1(j), 1.1295-1(k), and 1.1296-1(j).

FOR FURTHER INFORMATION CONTACT: Alexandra K. Helou, (202) 622-3840 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

On July 31, 2002, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-112306-00; 2002-44 I.R.B. 767) under section 1296 and related provisions of the Internal Revenue Code (Code). Two written comments were received in response to the notice of proposed rulemaking. No public hearing was requested or held on the notice of proposed rulemaking. After consideration of the comments, the proposed regulations are adopted as final regulations with the modifications discussed below.

Summary of Public Comments and Explanation of Changes

A. Deferral of Post-October PFIC Losses by Regulated Investment Companies (RICs) Under section 852(b)(10)

One commentator recommended that the regulations provide guidance regarding the determination of post-October "net reduction in value" of PFIC stock held by a RIC under section 852(b)(10). Section 852(b)(10) provides that taxable income of a RIC (other than a RIC to which an election under section 4982(e)(4) applies) shall be computed without regard to any net reduction in value occurring after October 31 of the taxable year of any stock of a PFIC with respect to which an election under section 1296(k) is in effect and that any such reduction shall be treated as occurring on the first day of the following taxable year.

To address concerns relating to a RIC's post-October period, the commentator provided three recommendations. First, that the regulations clarify whether the deferral of post-October PFIC losses under section 852(b)(10) is elective or mandatory; second, that RICs be permitted to defer their post-October losses under rules similar to those that apply to foreign currency gains and losses under §1.852-11; and third, that RICs be allowed to include actual post-October dispositions of PFIC stock when computing losses eligible for deferral.

The IRS and Treasury have considered these recommendations and determined that the issues raised with respect to section 852(b)(10) are issues under the RIC tax provisions that are beyond the scope of this regulations project.

B. Situations Arising From Different Tax Years of RICs and the Foreign Corporations in Which They Invest

One commentator requested guidance in instances where the RIC and a foreign corporation in which it invests have different or "mismatching" taxable years. This commentator noted that a RIC may experience uncertainties with respect to determining its taxable income and minimum distribution amount in situations where, following the end of its taxable year, the RIC learns that a foreign corporation in which it has invested is a PFIC or that the foreign corporation no longer satisfies the income or asset tests of section 1297(a) for the current taxable year. To address administrative concerns arising in this situation, this commentator recommended that RICs be permitted to recognize a change in a foreign corporation's PFIC status in the RIC's taxable year within which the taxable year of the foreign corporation ends.

Issues arising from different taxable years are not specific to PFICs for which a taxpayer has made a section 1296 election. Accordingly, this issue is beyond the scope of this regulations project. However, comments are requested for approaches that address issues arising when a taxpayer and a PFIC have different taxable years. Such issues may be addressed in a future regulations project.

C. Situations Where a RIC Owns Stock in a Foreign Corporation That No Longer Satisfies the PFIC Definition in the Current Year

One commentator suggested that the regulations should address certain issues that arise with respect to a shareholder that has made a section 1296 election for its PFIC stock and the foreign corporation does not satisfy the income or asset test in section 1297(a) for the year. First, the commentator suggested that the regulations clarify that the character of gains from the disposition of the stock of the foreign corporation during the time that the corporation did not qualify as a PFIC should be capital gain. The commentator also requested that the regulations provide that the character of losses with respect to stock for which a section 1296 election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC be treated as ordinary income to the extent of any unreversed inclusions at the time of disposition.

After consideration of these comments, and in accordance with the statutory provisions of section 1296, the IRS and Treasury have adopted the first comment, but not the second comment. Accordingly, two examples were added to the regulations. Example 2 in §1.1296-1(c)(7) clarifies that any gain from the disposition of stock of a foreign corporation that does not qualify as a PFIC for the year of disposition will be capital gain because section 1296(c)(1)(A) no longer applies at such time. In the case of losses with respect to stock for which a section 1296 election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC, Example 4 in §1.1296-1(c)(7) was added to clarify that any loss from the disposition of such stock will be a capital loss because section 1296(c)(1)(B) no longer applies at such time.

Second, the commentator recommended that the regulations provide automatic consent for RICs to terminate a section 1296 election during a year that a foreign corporation no longer satisfies the requirements for PFIC status. The IRS and Treasury have not adopted this recommendation. The IRS and Treasury believe that it is appropriate to require consent of the Commissioner to terminate a section 1296 election. Under §1.1296-1(h)(3), a shareholder can request the consent of the Commissioner to revoke a section 1296 election upon a finding of a substantial change in circumstances, which may include a foreign corporation ceasing to be a PFIC.

D. Technical Coordination Issues Arising From Marking PFIC Stock to Market Under the Former Proposed §1.1291-8 and Notice 92-53

A commentator suggested that the regulations should clarify how the former proposed §1.1291-8 (see Notice 92-53 (1992-2 C.B. 384)) and the current statutory PFIC mark to market rules under section 1296 interact. For example, the commentator requested clarification concerning the RIC's adjustments to the basis of its PFIC stock to reflect gains previously included under the former proposed §1.1291-8.

The IRS and Treasury believe that no additional clarification is needed. To the extent a taxpayer increased its basis or received a new holding period under the former proposed §1.1291-8, those consequences will be respected even though the proposed regulations were withdrawn without being finalized following the enactment of current section 1296 (see 64 FR 5015 (February 2, 1999) withdrawing proposed §1.1291-8). As a result, the suggestion was not adopted.

This same commentator also recommended that Example 2 of proposed §1.1296-1(i)(4) be clarified by specifically providing that the RIC had not made a mark to market election under the former proposed §1.1291-8. The commentator suggested this modification to eliminate potential ambiguities that may arise over the relationship between an election under the former proposed §1.1291-8 and section 1296. This suggestion was adopted, and the example has been revised accordingly.

E. The Regulations Should Allow Qualified Shareholders to Make Protective and Retroactive Mark to Market Elections

One commentator recommended that the regulations should provide rules similar to those contained in the qualified electing fund (QEF) regime for purposes of making a retroactive QEF election. The IRS and Treasury have considered this comment and continue to believe that the appropriate process for retroactive relief for late mark to market elections is under the §301.9100 relief provisions, as set forth in §1.1296-1(h)(1)(iii). Accordingly, this suggestion was not adopted.

F. Termination of Existing Section 1296 Mark to Market Elections Without the Consent of the Commissioner

One commentator suggested permitting a taxpayer with an existing section 1296 election to make a QEF election and terminate its existing 1296 election without the consent of the Commissioner. The proposed regulations were structured to facilitate an election for mark to market treatment by permitting a taxpayer with an existing QEF election to make a section 1296 election and terminate the existing QEF election without requiring the consent of the Commissioner. Conversely, a taxpayer with an existing section 1296 election is permitted to make a QEF election only if the section 1296 election is terminated as provided by section 1296 and the regulations thereunder (e.g., if the PFIC stock ceases to be marketable) or is revoked with consent of the Commissioner. This approach reflects consideration of the relative administrative burdens imposed under each set of rules, and the stated intent of Congress that one of the purposes for enacting section 1296 was to provide another alternative to the interest charge rules of section 1291 that would be available in instances where taxpayers cannot obtain sufficient information to make a QEF election. See H.R. Rep. No. 105-148, at 533 (1997); S. Rep. No. 105-33 at 94 (1997). After consideration of the comment, the IRS and Treasury continue to believe the rules coordinating QEF elections and mark to market elections under section 1296 are appropriate for the reasons discussed above. Accordingly, this recommendation was not adopted.

G. Proposals to Enhance the Utility of QEF Elections for RICs

One commentator provided two suggestions focused on enhancing the utility of QEF elections for RICs. Specifically, the commentator first suggested allowing RICs to use U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS) for purposes of computing QEF inclusions under section 1295(a)(2). The commentator also suggested revising the retroactive QEF election rules in cases where a RIC learns of the PFIC status of a foreign corporation immediately prior to the deadline for making a QEF election. These comments, which raise issues regarding the QEF rules, are beyond the scope of this regulation. Accordingly, these comments were not adopted but will be considered in the context of any guidance to be issued under the appropriate substantive provisions.

H. Additional Revisions

The final regulations also clarify that the regulations apply to taxable years beginning on or after May 3, 2004. Additionally, the several examples in proposed

§1.1296-1(c) have been grouped together in new §1.1296-1(c)(7) in order to make the regulation more readable.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes; Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Section 1.1296-1 also issued under 26 USC 1296(g) and 26 USC 1298(f). * * *

Par. 2. §1.1291-0 (table of contents) is amended by revising the introductory text and by adding the entries for §1.1291-1 to read as follows:

§1.1291-0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

This section contains a listing of the headings for §§1.1291-1, 1.1291-9, and 1.1291-10.

§1.1291-1 Taxation of U.S. persons that are shareholders of section 1291 funds.
(a) through (b) [Reserved].
(c) Coordination with other PFIC rules.
(1) and (2) [Reserved].
(3) Coordination with section 1296: distributions and dispositions.
(4) Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296.
(i) In general.
(ii) Coordination rule.
(d) [Reserved].
(e) Exempt organization as shareholder.
(1) In general.
(2) Effective date.
(f) through (i) [Reserved].
(j) Effective date.

* * * * *

Par. 3. Section 1.1291-1 is amended by:

1. Revising paragraphs (a) through (d).

2. Adding paragraphs (f) through (j).

The revisions and additions read as follows:

' 1.1291-1 Taxation of U.S. persons that are shareholders of section 1291 funds.

(a) and (b) [Reserved].

(c) Coordination with other PFIC rules.

(1) and (2) [Reserved].

(3) Coordination with section 1296: distributions and dispositions. If PFIC stock is marked to market under section 1296 for any taxable year, then, except as provided in ' 1.1296-1(i), section 1291 and the regulations thereunder shall not apply to any distribution with respect to section 1296 stock (as defined in ' 1.1296-1(a)(2)), or to any disposition of such stock, for such taxable year.

(4) Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296--(i) In general. If PFIC stock is marked to market for any taxable year under section 475 or any other provision of chapter 1 of the Internal Revenue Code, other than section 1296, regardless of whether the application of such provision is mandatory or results from an election by the taxpayer or another person, then, except as provided in paragraph (c)(4)(ii) of this section, section 1291 and the regulations thereunder shall not apply to any distribution with respect to such PFIC stock or to any disposition of such PFIC stock for such taxable year. See ' ' 1.1295-1(i)(3) and 1.1296-1(h)(3)(i) for rules regarding the automatic termination of an existing election under section 1295 or section 1296 when a taxpayer marks to market PFIC stock under section 475 or any other provision of chapter 1 of the Internal Revenue Code.

(ii) Coordination rule--(A) Notwithstanding any provision in this section to the contrary, the rule of paragraph (c)(4)(ii)(B) of this section shall apply to the first taxable year in which a United States person marks to market its PFIC stock under a provision of chapter 1 of the Internal Revenue Code, other than section 1296, if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person=s holding period (as defined in section 1291(a)(3)(A) and ' 1.1296-1(f)) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(B) For the first taxable year of a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Internal Revenue Code, other than section 1296, such United States person shall, in lieu of the rules under which the United States person marks to market, apply the rules of ' 1.1296-1(i)(2) and (3) as if the United States person had made an election under section 1296 for such first taxable year.

(d) [Reserved].

* * * * *

(f) through (i) [Reserved].

(j) Effective dates. This section applies for taxable years beginning on or after May 3, 2004, except as otherwise provided in paragraph (e)(2) of this section.

Par. 4. §1.1295-0 (table of contents) is amended by:

1. Revising the entries for §1.1295-1(i)(3) and (i)(4) and adding paragraph (i)(5), (i)(5)(i), and (i)(5)(ii).

2. Revising the entry for §1.1295-1(k).

The revisions and addition read as follows:

§1.1295-0 Table of contents. * * *

§1.1295-1 Qualified electing funds.

* * * * *

(i) * * *

(3) Automatic termination.

(4) Effect of invalidation, termination or revocation.

(5) Election after invalidation, termination or revocation.

(i) In general.

(ii) Special rule.

* * * * *

(k) Effective dates.

* * * * *

§1.1295-1 Qualified electing funds.

Par. 5. Section 1.1295-1 is amended by:

1. Redesignating paragraphs (i)(3) and (i)(4) as paragraphs (i)(4) and (i)(5), respectively.

2. Adding a new paragraph (i)(3).

3. Revising newly designated paragraph (i)(5).

4. Revising paragraph (k).

The revisions and addition read as follows:

' 1.1295-1 Qualified electing funds

* * * * *

(i) * * *

(3) Automatic termination. If a United States person, or the United States shareholder on behalf of a controlled foreign corporation, makes an election pursuant to section 1296 and the regulations thereunder with respect to PFIC stock for which a QEF election is in effect, or marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, the QEF election is automatically terminated with respect to such stock that is marked to market under section 1296 or another provision of chapter 1 of the Internal Revenue Code. Such termination shall be effective on the last day of the shareholder=s taxable year preceding the first taxable year for which the section 1296 election is in effect or such stock is marked to market under another provision of chapter 1 of the Internal Revenue Code.

Example. Corp Y, a domestic corporation, owns directly 100 shares of marketable stock in foreign corporation FX, a PFIC. Corp Y also owns a 50 percent interest in FP, a foreign partnership that owns 200 shares of FX stock. Accordingly, under section 1298(a)(3) and '1.1296-1(e)(1), Corp Y is treated as indirectly owning 100 shares of FX stock. Corp Y also owns 100 percent of the stock of FZ, a foreign corporation that is not a PFIC. FZ owns 100 shares of FX stock, and therefore under section 1298(a)(2)(A), Corp Y is treated as owning the 100 shares of FX stock owned by FZ. For taxable year 2005, Corp Y has a QEF election in effect with respect to all 300 shares of FX stock that it owns directly or indirectly. See generally '1.1295-1(c)(1). For taxable year 2006, Corp Y makes a timely election pursuant to section 1296 and the regulations thereunder. For purposes of section 1296, Corp Y is treated as owning stock held indirectly through a partnership, but not through a foreign corporation. Section 1296(g); '1.1296-1(e)(1). Accordingly, Corp Y=s section 1296 election covers the 100 shares it owns directly and the 100 shares it owns indirectly through FP, but not the 100 shares owned by FZ. With respect to the first 200 shares, Corp Y=s QEF election is automatically terminated effective December 31, 2005. With respect to the 100 shares Corp Y owns through foreign FZ, Corp Y=s QEF election remains in effect unless invalidated, terminated, or revoked pursuant to this paragraph (i).

* * * * *

(5) Effect after invalidation, termination, or revocation-- (i) In general. Without the Commissioner=s consent, a shareholder whose section 1295 election was invalidated, terminated, or revoked under this paragraph (i) may not make the section 1295 election with respect to the PFIC before the sixth taxable year in which the invalidation, termination, or revocation became effective.

(ii) Special rule. Notwithstanding paragraph (i)(5)(i) of this section, a shareholder whose section 1295 election was terminated pursuant to paragraph (i)(3) of this section, and either whose section 1296 election has subsequently been terminated because its PFIC stock ceased to be marketable or who no longer marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, may make a section 1295 election with respect to its PFIC stock before the sixth taxable year in which its prior section 1295 election was terminated.

* * * * *

(k) Effective dates. Except as otherwise provided, paragraphs (b)(2)(iii), (b)(3), (b)(4), and (c) through (j) of this section are applicable to taxable years of shareholders beginning after December 31, 1997. However, taxpayers may apply the rules under paragraphs (b)(4), (f) and (g) of this section to a taxable year beginning before January 1, 1998, provided the statute of limitations on the assessment of tax has not expired as of April 27, 1998, and, in the case of paragraph (b)(4) of this section, the taxpayers who filed the joint return have consistently applied the rules of that section to all taxable years following the year the election was made. Paragraph (b)(3)(v) of this section is applicable as of February 7, 2000, however, a taxpayer may apply the rules to a taxable year prior to the applicable date provided the statute of limitations on the assessment of tax for that taxable year has not expired. Paragraphs (i)(3) and (i)(5)(ii) of this section are applicable for taxable years beginning on or after May 3, 2004.

Par. 6. Section 1.1296-1 is added to read as follows:

' 1.1296-1 Mark to market election for marketable stock.

(a) Definitions--(1) Eligible RIC. An eligible RIC is a regulated investment company that offers for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, or that publishes net asset valuations at least annually.

(2) Section 1296 stock. The term section 1296 stock means marketable stock in a passive foreign investment company (PFIC), including any PFIC stock owned directly or indirectly by an eligible RIC, for which there is a valid section 1296 election. Section 1296 stock does not include stock of a foreign corporation that previously had been a PFIC, and for which a section 1296 election remains in effect.

(3) Unreversed inclusions--(i) General rule. The term unreversed inclusions means with respect to any section 1296 stock, the excess, if any, of--

(A) The amount of mark to market gain included in gross income of the United States person under paragraph (c)(1) of this section with respect to such stock for prior taxable years; over

(B) The amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock for prior taxable years.

(ii) Section 1291 adjustment. The amount referred to in paragraph (a)(3)(i)(A) of this section shall include any amount subject to section 1291 under the coordination rule of paragraph (i)(2)(ii) of this section.

(iii) Example. An example of the computation of unreversed inclusions is as follows:

Example. A, a United States person, acquired stock in Corp X, a foreign corporation, on January 1, 2005 for $150. At such time and at all times thereafter, Corp X was a PFIC and A=s stock in Corp X was marketable. For taxable years 2005 and 2006, Corp X was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the X stock, effective for taxable year 2007. The fair market value of the X stock was $200 as of December 31, 2006, and $240 as of December 31, 2007. Additionally, Corp X made no distribution with respect to its stock for the taxable years at issue. In 2007, pursuant to paragraph (i)(2)(ii) of this section, A must include the $90 gain in the X stock in accordance with the rules of section 1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions pursuant to paragraph (a)(3)(ii) of this section, A will include the $90 of gain that was taxed under section 1291 and not the interest thereon.

(iv) Special rule for regulated investment companies. In the case of a regulated investment company which had elected to mark to market the PFIC stock held by such company as of the last day of the taxable year preceding such company's first taxable year for which such company makes a section 1296 election, the amount referred to in paragraph (a)(3)(i)(A) of this section shall include amounts previously included in gross income by the company pursuant to such mark to market election with respect to such stock for prior taxable years. For further guidance, see Notice 92-53 (1992-2 C.B. 384) (see also 601.601(d)(2) of this chapter).

(b) Application of section 1296 election--(1) In general. Any United States person and any controlled foreign corporation (CFC) that owns directly, or is treated as owning under this section, marketable stock, as defined in '1.1296-2, in a PFIC may make an election to mark to market such stock in accordance with the provisions of section 1296 and this section.

(2) Election applicable to specific United States person. A section 1296 election applies only to the United States person (or CFC that is treated as a U.S. person under

paragraph (g)(2) of this section) that makes the election. Accordingly, a United States person=s section 1296 election will not apply to a transferee of section 1296 stock.

(3) Election applicable to specific corporation only. A section 1296 election is made with respect to a single foreign corporation, and thus a separate section 1296 election must be made for each foreign corporation that otherwise meets the requirements of this section. A United States person=s section 1296 election with respect to stock in a foreign corporation applies to all marketable stock of the corporation that the person owns directly, or is treated as owning under paragraph (e) of this section, at the time of the election or that is subsequently acquired.

(c) Effect of election--(1) Recognition of gain. If the fair market value of section 1296 stock on the last day of the United States person=s taxable year exceeds its adjusted basis, the United States person shall include in gross income for its taxable year the excess of the fair market value of such stock over its adjusted basis (mark to market gain).

(2) Character of gain. Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated as ordinary income.

(3) Recognition of loss. If the adjusted basis of section 1296 stock exceeds its fair market value on the last day of the United States person=s taxable year, such person shall be allowed a deduction for such taxable year equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock (mark to market loss).

(4) Character of loss--(i) Losses not in excess of unreversed inclusions. Any mark to market loss allowed as a deduction under paragraph (c)(3) of this section, and any loss on the sale or other disposition of section 1296 stock, to the extent that such loss does not

exceed the unreversed inclusions attributable to such stock, shall be treated as an ordinary loss, deductible in computing adjusted gross income.

(ii) Losses in excess of unreversed inclusions. Any loss recognized on the sale or other disposition of section 1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Internal Revenue Code and the regulations thereunder.

(5) Application of election to separate lots of stock. In the case in which a United States person purchased or acquired shares of stock in a PFIC at different prices, the rules of this section shall be applied in a manner consistent with the rules of '1.1012-1.

(6) Source rules. The source of any amount included in gross income under paragraph (c)(1) of this section, or the allocation and apportionment of any amount allowed as a deduction under paragraph (c)(3) of this section, shall be determined in the same manner as if such amounts were gain or loss (as the case may be) from the sale of stock in the PFIC.

(7) Examples. The following examples illustrate this paragraph (c):

Example 1. Treatment of gain as ordinary income. A, a United States individual, purchases stock in FX, a foreign corporation that is not a PFIC, in 1990 for $1,000. On January 1, 2005, when the fair market value of the FX stock is $1,100, FX becomes a PFIC. A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the FX stock is $1,200. For taxable year 2005, A includes $200 of mark to market gain (the excess of the fair market value of FX stock ($1,200) over A=s adjusted basis ($1,000)) in gross income as ordinary income and pursuant to paragraph (d)(1) of this section increases his basis in the FX stock by that amount.

Example 2. Treatment of gain as capital gain. The facts are the same as in Example 1. For taxable year 2006, FX does not satisfy either the asset test or the income test of section 1297(a). A does not revoke the section 1296 election it made with respect to the FX stock. On December 1, 2006, A sells the FX stock when the fair market value of the stock is $1,500. For taxable year 2006, A includes $300 of gain (the excess of the fair market value of FX stock ($1,500) over A's adjusted basis ($1,200)) in gross income as long-term capital gain because at the time of sale of the FX stock by A, FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period for non-PFIC purposes was more than one year.

Example 3. Treatment of losses as ordinary where they do not exceed unreversed inclusions. The facts are the same as in Example 1. On December 1, 2006, A sells the stock in FX for $1,100. At that time, A=s unreversed inclusions (the amount A included in income as mark to market gain) with respect to the stock in FX are $200. Accordingly, for taxable year 2006, A recognizes a loss on the sale of the FX stock of $100, (the fair market value of the FX stock ($1,100) minus A's adjusted basis ($1,200) in the stock) that is treated as an ordinary loss because the loss does not exceed the unreversed inclusions attributable to the stock of FX.

Example 4. Treatment of losses as long-term capital losses. The facts are the same as in Example 3, except that FX does not satisfy either the asset test or the income test of section 1297(a) for taxable year 2006. For taxable year 2006, A's $100 loss from the sale of the FX stock is treated as long-term capital loss because at the time of the sale of the FX stock by A FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period in the FX stock for non-PFIC purposes was more than one year.

Example 5. Long-term capital loss treatment of losses in excess of unreversed inclusions. The facts are the same as in Example 3, except that A sells his FX stock for $900. At the time of A's sale of the FX stock on December 1, 2006, A=s unreversed inclusions with respect to the FX stock are $200. Accordingly, the $300 loss recognized by A on the disposition is treated as an ordinary loss to the extent of his unreversed inclusions ($200). The amount of the loss in excess of A=s unreversed inclusions ($100) will be treated as a long-term capital loss because A's holding period in the FC stock for non-PFIC purposes was more than one year.

Example 6. Application of section 1296 election to separate lots of stock. On January 1, 2005, Corp A, a domestic corporation, purchased 100 shares (first lot) of stock in FX, a PFIC, for $500 ($5 per share). On June 1, 2005, Corp A purchased 100 shares (second lot) of FX stock for $1,000 ($10 per share). Corp A made a timely section 1296 election with respect to its FX stock for taxable year 2005. On December 31, 2005, the fair market value of FX stock was $8 per share. For taxable year 2005, Corp A includes $300 of gain in gross income as ordinary income under paragraph (c)(1) of this section with respect to the first lot, and adjusts its basis in that lot to $800 pursuant to paragraph (d)(1) of this section. With respect to the second lot, Corp A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year

2005. Although Corp A=s adjusted basis in that stock exceeds its fair market value by $200, Corp A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2006, Corp A sells 100 shares of FX stock for $900. Assuming that Corp A adequately identifies (in accordance with the rules of ' 1.1012-1(c)) the shares of FX stock sold as being from the second lot, Corp A recognizes $100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

(d) Adjustment to basis--(1) Stock held directly. The adjusted basis of the section 1296 stock shall be increased by the amount included in the gross income of the United States person under paragraph (c)(1) of this section with respect to such stock, and decreased by the amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock.

(2) Stock owned through certain foreign entities. (i) In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the basis adjustments under paragraph (d)(1) of this section shall apply to such stock in the hands of the foreign entity actually holding such stock, but only for purposes of determining the subsequent treatment under chapter 1 of the Internal Revenue Code of the United States person with respect to such stock. Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person=s interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

(ii) Example. The following example illustrates this paragraph (d)(2):

Example. FP is a foreign partnership. Corp A, a domestic corporation, owns a 20 percent interest in FP. Corp B, a domestic corporation, owns a 30 percent interest in FP. Corp C, a foreign corporation, with no direct or indirect shareholders that are U.S. persons, owns a 50% interest in FP. Corp A, Corp B, and FP all use a calendar year for their taxable year. In 2005, FP purchases stock in FX, a foreign corporation and a PFIC, for $1,000. Corp A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the PFIC stock is $1,100. Corp A includes $20 of ordinary income in taxable year 2005 under paragraphs (c)(1) and (2) of this section. Corp A increases its basis in its FP partnership interest by $20. FP increases its basis in the FX stock to $1,020 solely for purposes of determining the subsequent treatment of Corp A, under chapter 1 of the Internal Revenue Code, with respect to such stock. In 2006, FP sells the FX stock for $1,200. For purposes of determining the amount of gain of Corp A, FP will be treated as having $180 in gain of which $20 is allocated to Corp A. Corp A=s $20 of gain will be treated as ordinary income under paragraph (c)(2) of this section. For purposes of determining the amount of gain attributable to Corp B, FP will be treated as having $200 gain, $60 of which will be allocated to Corp B.

(3) Stock owned indirectly by an eligible RIC. Paragraph (d)(2) of this section shall also apply to an eligible RIC which is an indirect shareholder under ' 1.1296-2(f) of stock in a PFIC and has a valid section 1296 election in effect with respect to the PFIC stock.

(4) Stock acquired from a decedent. In the case of stock of a PFIC which is acquired by bequest, devise, or inheritance (or by the decedent=s estate) and with respect to which a section 1296 election was in effect as of the date of the decedent=s death, notwithstanding section 1014, the basis of such stock in the hands of the person so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis which would have been determined under section 1014 without regard to this paragraph).

(5) Transition rule for individuals becoming subject to United States income taxation--(i) In general. If any individual becomes a United States person in a taxable year beginning after December 31, 1997, solely for purposes of this section, the

adjusted basis, before adjustments under this paragraph (d), of any section 1296 stock owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value or its adjusted basis on such first day.

(ii) An example of the transition rule for individuals becoming subject to United States income taxation is as follows:

Example. A, a nonresident alien individual, purchases marketable stock in FX, a PFIC, for $50 in 1995. On January 1, 2005, A becomes a United States person and makes a timely section 1296 election with respect to the stock in accordance with paragraph (h) of this section. The fair market value of the FX stock on January 1, 2005, is $100. The fair market value of the FX stock on December 31, 2005, is $110. Under paragraph (d)(5)(i) of this section, A computes the amount of mark to market gain or loss for the FX stock in 2005 by reference to an adjusted basis of $100, and therefore A includes $10 in gross income as mark to market gain under paragraph (c)(1) of this section. Additionally, under paragraph (d)(1) of this section, A=s adjusted basis in the FX stock for purposes of this section is increased to $110 (and to $60 for all other tax purposes). A sells the FX stock in 2006 for $120. For purposes of applying section 1001, A must use its original basis of $50, with any adjustments under paragraph (d)(1) of this section, $10 in this case, and therefore A recognizes $60 of gain. Under paragraph (c)(2) of this section (which is applied using an adjusted basis of $110), $10 of such gain is treated as ordinary income. The remaining $50 of gain from the sale of the FX stock is long term capital gain because A held such stock for more than one year.

(e) Stock owned through certain foreign entities--(1) In general. Except as provided in paragraph (e)(2) of this section, the following rules shall apply in determining stock ownership for purposes of this section. PFIC stock owned, directly or indirectly, by or for a foreign partnership, foreign trust (other than a foreign trust described in sections 671 through 679), or foreign estate shall be considered as being owned proportionately by its partners or beneficiaries. PFIC stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679 shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock. The determination of a person=s proportionate interest in a foreign partnership, foreign trust or foreign estate will be made on the basis of all the facts and circumstances. Stock considered owned by reason of this paragraph shall, for purposes of applying the rules of this section, be treated as actually owned by such person.

(2) Stock owned indirectly by eligible RICs. The rules for attributing ownership of stock contained in ' 1.1296-2(f) will apply to determine the indirect ownership of PFIC stock by an eligible RIC.

(f) Holding period. Solely for purposes of sections 1291 through 1298, if section 1296 applied to stock with respect to the taxpayer for any prior taxable year, the taxpayer=s holding period in such stock shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied.

(g) Special rules--(1) Certain dispositions of stock. To the extent a United States person is treated as actually owning stock in a PFIC under paragraph (e) of this section, any disposition which results in the United States person being treated as no longer owning such stock, and any disposition by the person owning such stock, shall be treated as a disposition by the United States person of the stock in the PFIC.

(2) Treatment of CFC as a United States person. In the case of a CFC that owns, or is treated as owning under paragraph (e) of this section, section 1296 stock:

(i) Other than with respect to the sourcing rules in paragraph (c)(6) of this section, this section shall apply to the CFC in the same manner as if such corporation were a United States person. The CFC will be treated as a foreign person for purposes of applying the source rules of paragraph (c)(6).

(ii) For purposes of subpart F of part III of subchapter N of the Internal Revenue Code--

(A) Amounts included in the CFC=s gross income under paragraph (c)(1) or (i)(2)(ii) of this section shall be treated as foreign personal holding company income under section 954(c)(1)(A); and

(B) Amounts allowed as a deduction under paragraph (c)(3) of this section shall be treated as a deduction allocable to foreign personal holding company income for purposes of computing net foreign base company income under ' 1.954-1(c).

(iii) A United States shareholder, as defined in section 951(b), of the CFC shall not be subject to section 1291 with respect to any stock of the PFIC for the period during which the section 1296 election is in effect for that stock, and the holding period rule of paragraph (f) of this section shall apply to such United States shareholder.

(iv) The rules of this paragraph (g)(2) shall not apply to a United States person that is a shareholder of the PFIC for purposes of section 1291, but is not a United States shareholder under section 951(b) with respect to the CFC making a section 1296 election.

(3) Timing of inclusions for stock owned through certain foreign entities. In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the mark to market gain or mark to market loss is determined in accordance with paragraphs (c) and (i)(2)(ii) of this section as of the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then included in the taxable year of such United States person that includes the last day of the taxable year of the entity.

(h) Elections--(1) Timing and manner for making a section 1296 election--(i) United States persons. A United States person that owns marketable stock in a PFIC, or is treated as owning marketable stock under paragraph (e) of this section, on the last day of the taxable year of such person, and that wants to make a section 1296 election, must make a section 1296 election for such taxable year on or before the due date (including extensions) of the United States person=s income tax return for that year. The section 1296 election must be made on the Form 8621, AReturn by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund@, included with the original tax return of the United States person for that year, or on an amended return, provided that the amended return is filed on or before the election due date.

(ii) Controlled foreign corporations. A section 1296 election by a CFC shall be made by its controlling United States shareholders, as defined in '1.964-1(c)(5), and shall be included with the Form 5471, AInformation Return of U.S. Persons With Respect To Certain Foreign Corporations@, for that CFC by the due date (including extensions) of the original income tax returns of the controlling United States shareholders for that year. A section 1296 election by a CFC shall be binding on all United States shareholders of the CFC.

(iii) Retroactive elections for PFIC stock held in prior years. A late section 1296 election may be permitted only in accordance with '301.9100 of this chapter.

(2) Effect of section 1296 election--(i) A section 1296 election will apply to the taxable year for which such election is made and remain in effect for each succeeding taxable year unless such election is revoked or terminated pursuant to paragraph (h)(3) of this section.

(ii) Cessation of a foreign corporation as a PFIC. A United States person will not include mark to market gain or loss pursuant to paragraph (c) of this section with respect to any stock of a foreign corporation for any taxable year that such foreign corporation is not a PFIC under section 1297 or treated as a PFIC under section 1298(b)(1) (taking into account the holding period rule of paragraph (f) of this section).

Cessation of a foreign corporation=s status as a PFIC will not, however, terminate a section 1296 election. Thus, if a foreign corporation is a PFIC in a taxable year after a year in which it is not treated as a PFIC, the United States person=s original election (unless revoked or terminated in accordance with paragraph (h)(3) of this section) continues to apply and the shareholder must include any mark to market gain or loss in such year.

(3) Revocation or termination of election--(i) In general. A United States person=s section 1296 election is terminated if the section 1296 stock ceases to be marketable; if the United States person elects, or is required, to mark to market the section 1296 stock under another provision of chapter 1 of the Internal Revenue Code; or if the Commissioner, in the Commissioner=s discretion, consents to the United States person=s request to revoke its section 1296 election upon a finding of a substantial change in circumstances. A substantial change in circumstances for this purpose may include a foreign corporation ceasing to be a PFIC.

(ii) Timing of termination or revocation. Where a section 1296 election is terminated automatically (e.g., the stock ceases to be marketable), section 1296 will cease to apply beginning with the taxable year in which such termination occurs. Where a section 1296 election is revoked with the consent of the Commissioner, section 1296 will cease to apply beginning with the first taxable year of the United States person after the revocation is granted unless otherwise provided by the Commissioner.

(4) Examples. The operation of the rules of this paragraph (h) is illustrated by the following examples:

Example 1. A, a United States person, owns stock in FX, a PFIC. A makes a QEF election in 1996 with respect to the FX stock. For taxable year 2005, A makes a timely section 1296 election with respect to its stock, and thus its QEF election is automatically terminated pursuant to ' 1.1295-1(i)(3). In 2006, A=s stock in FX ceases to be marketable, and therefore its section 1296 election is automatically terminated under paragraph (h)(3) of this section. Beginning with taxable year 2006, A is subject to the rules of section 1291 with respect to its FX stock unless it makes a new QEF election. See '1.1295-1(i)(5).

Example 2. The facts are the same as in Example 1, except that A=s stock in FX becomes marketable again in 2007. A may make a new section 1296 election with respect to the FX stock for its taxable year 2007, or thereafter. A will be subject to the coordination rules under paragraph (i) of this section unless it made a new QEF election in 2006.

(i) Coordination rules for first year of election--(1) In general. Notwithstanding any provision in this section to the contrary, the rules of this paragraph (i) shall apply to the first taxable year in which a section 1296 election is effective with respect to marketable stock of a PFIC if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person=s holding period (as defined in paragraph (f) of this section) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(2) Shareholders other than regulated investment companies. For the first taxable year of a United States person (other than a regulated investment company) for which a section 1296 election is in effect with respect to the stock of a PFIC, such United States person shall, in lieu of the rules of paragraphs (c) and (d) of this section--

(i) Apply the rules of section 1291 to any distributions with respect to, or disposition of, section 1296 stock;

(ii) Apply section 1291 to the amount of the excess, if any, of the fair market value of such section 1296 stock on the last day of the United States person=s taxable year over its adjusted basis, as if such amount were gain recognized from the disposition of stock on the last day of the taxpayer=s taxable year; and

(iii) Increase its adjusted basis in the section 1296 stock by the amount of excess, if any, subject to section 1291 under paragraph (i)(2)(ii) of this section.

(3) Shareholders that are regulated investment companies. For the first taxable year of a regulated investment company for which a section 1296 election is in effect with respect to the stock of a PFIC, such regulated investment company shall increase its tax under section 852 by the amount of interest that would have been imposed under section 1291(c)(3) for such taxable year if such regulated investment company were subject to the rules of paragraph (i)(2) of this section, and not this paragraph (i)(3). No deduction or increase in basis shall be allowed for the increase in tax imposed under this paragraph (i)(3).

(4) The operation of the rules of this paragraph (i) is illustrated by the following examples:

Example (1). A, a United States person and a calendar year taxpayer, owns marketable stock in FX, a PFIC that it acquired on January 1, 1992. At all times, A=s FX stock was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election effective for taxable year 2005. At the close of taxable year 2005, the fair market value of A=s FX stock exceeded its adjusted basis by $10. Pursuant to paragraph (i)(2)(ii) of this section, A must treat the $10 gain under section 1291 as if the FX stock were disposed of on December 31, 2005. Further, A increases its adjusted basis in the FX stock by the $10 in accordance with paragraph (i)(2)(iii) of this section.

Example (2). Assume the same facts as in Example (1), except that A is a RIC that had not made an election prior to 2005 to mark to market the PFIC stock. In taxable year 2005, A includes $10 of ordinary income under paragraph (c)(1) of this section, and such amount is not subject to section 1291. A also increases its tax imposed under section 852 by the amount of interest that would have been determined under section 1291(c)(3), and no deduction is permitted for such amount. Finally, under paragraph (d)(1) of this section, A increases its adjusted basis in the FX stock by $10.

(j) Effective date. The provisions in this section are applicable for taxable years beginning on or after May 3, 2004.

Par. 7. Section 1.1296(e)-1 is redesignated as §1.1296-2 and amended by:

1. Revising paragraph (b)(2).

2. Adding paragraph (b)(3).

3. Revising both references to Asections 958(a)(1) and (2)@ in paragraph (f)(1) to read Asection 1298(a)@.

The revisions and addition read as follows:

' 1.1296-2 Definition of marketable stock.

* * * * *

(b) * * *

(2) Special rule for year of initial public offering. For the calendar year in which a corporation initiates a public offering of a class of stock for trading on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, such class of stock meets the requirements of paragraph (b)(1) of this section for such year if the stock is regularly traded on such exchanges or markets, other than in de minimis quantities, on 1/6 of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the taxpayer=s calendar year. In cases where a corporation initiates a public offering of a class of stock in the fourth quarter of the calendar year, such class of stock meets the requirements of paragraph (b)(1) of this section in the calendar year of the offering if the stock is regularly traded on such exchanges or markets, other than in de minimis quantities, on the greater of 1/6 of the days remaining in the quarter in which the offering occurs, or 5 days.

(3) Anti-abuse rule. Trades that have as one of their principal purposes the meeting of the trading requirements of paragraph (b)(1) or (2) of this section shall be disregarded. Further, a class of stock shall not be treated as meeting the trading requirement of paragraph (b)(1) or (2) of this section if there is a pattern of trades conducted to meet the requirement of paragraph (b)(1) or (2) of this section. Similarly, paragraph (b)(2) of this section shall not apply to a public offering of stock that has as one of its principal purposes to avail itself of the reduced trading requirements under the special rule for the calendar year of an initial public offering. For purposes of applying the immediately preceding sentence, consideration will be given to whether the trading requirements of paragraph (b)(1) of this section are satisfied in the subsequent calendar year.

* * * * *

Par. 8. Section 1.6031(a)-1 is amended by:

1. Redesignating the text of paragraph (b)(1) as (b)(1)(i).

2. Adding a heading to newly designated paragraph (b)(1)(i).

3. Adding paragraph (b)(1)(ii).

The additions read as follows:

' 1.6031(a)-1 Return of Partnership income.

* * * * *

(b) * * * (1) * * * (i) Filing requirement. * * *

(ii) Special rule. For purposes of this paragraph (b)(1) and paragraph (b)(3)(iii) of this section, a foreign partnership will not be considered to have derived income from sources within the United States solely because a U.S. partner marks to market his pro rata share of PFIC stock held by the foreign partnership pursuant to an election under section 1296.

* * * * *

Mark E. Matthews,

Deputy Commissioner of Services and Enforcement.

Approved: April 7, 2004.

Gregory F. Jenner,

Acting Assistant Secretary of the Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

April 29, 2004
js-1495

Treasury Department Announces a Request for Comments On the "Make Available" Determination

The Treasury Department today announced a request for comments regarding the requirement of the Terrorism Risk Insurance Act (TRIA) of 2002 that the Secretary of the Treasury determine whether to extend the "make available" requirements of the Act into the third year of the program (i.e., through December 31, 2005). The Secretary of the Treasury is required to make this determination by September 1, 2004. Comments will be accepted for 30 days from when the notice is published in the *Federal Register*.

The "make available" provisions of TRIA require that, from the date of enactment (November 26, 2002) through the last day of the second year of the program (December 31, 2004), each insurer must make available, in all of its commercial property and casualty insurance policies, coverage for insured losses under the Act. In this regard, TRIA also requires that such insurance coverage must not differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism.

"We encourage any who have views on the questions set forth in the request for comments to share those views with Treasury as soon as they can, with as much detail as they can provide," said Treasury Assistant Secretary Abernathy, who oversees the Terrorism Risk Insurance Program. "We hope that this broad request for public input on the 'make available' determination will facilitate the efforts of the Secretary to make a timely determination based upon a solid basis of information and views provided from all parts of the nation and from a wide variety of citizens, businesses, industry experts, and others."

The request for comments and other information related to the Terrorism Risk Insurance Program can be found at: http://www.treasury.gov/trip.

REPORTS

- Trip Make Avail Fed Reg 4.29.04

DEPARTMENT OF THE TREASURY

Departmental Offices

Treasury's Decision to Extend the Terrorism Risk Insurance Act's "Make Available" Requirement

AGENCY: Department of the Treasury, Departmental Offices

ACTION: Notice; Request for Comments

SUMMARY: Title I of the Terrorism Risk Insurance Act of 2002 (Pub. L. 107-297) requires that, from the date of enactment (November 26, 2002) through the last day of Program Year 2 (December 31, 2004), each insurer must make available, in all of its property and casualty insurance policies, coverage for insured losses under the Act. In this regard, the Act requires that such insurance coverage must not differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism. In addition, the Act requires the Secretary of the Treasury (Treasury) to determine, no later than September 1, 2004, whether to extend these statutory make available requirements through Program Year 3 (December 31, 2005). To obtain additional information to assist Treasury in its determination, the Treasury solicits public comment on the questions listed below.

DATES: Comments must be in writing and received by [30 days after publication in the Federal Register].

ADDRESSES: Send comments by e-mail to triacomments@do.treas.gov. Please include your name, affiliation, address, e-mail address, and telephone number. All submissions should be captioned "Comments on Make Available Determination."

FOR FURTHER INFORMATION CONTACT: Mario Ugoletti, Acting Director, Office of Financial Institutions Policy, 202-622-0715; Roy Woodall, Senior Insurance Analyst, Office of Financial Institutions Policy, 202-622-5171; U.S. Treasury Department (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

On November 26, 2002, President Bush signed into law the Terrorism Risk Insurance Act of 2002 (the Act). The Act was effective immediately. Title I of the Act established a temporary federal program of shared public and private compensation for insured commercial property and casualty insured losses resulting from an act of terrorism as defined by the Act. The Act authorized Treasury to administer and implement the three year Terrorism Risk Insurance Program which ends on December 31, 2005.

Section 103(c)(1) of the Act requires each entity that meets the definition of an insurer under the Act to (A) make available, in all of its property and casualty insurance polices coverage for insured losses; and (B) make available property and casualty insurance coverage for insured losses that does not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism. These requirements apply from the date of enactment (November 26, 2002) through the last day of Program Year 2 (December 31, 2004).[1]

In addition, section 103(c)(2) of the Act requires Treasury to determine, no later than September 1, 2004, whether to extend the "make available" requirements of section 103(c)(1) through Program Year 3 (December 31, 2005). (Regardless of whether the make available requirements are extended by Treasury through Program Year 3, we note that the overall Program and the Act's federal backstop for insured losses for acts of terrorism continue though December 31, 2005.) The Treasury determination on whether to extend the make available requirements through Program Year 3 is to be based on the factors referred to in section 108(d)(1) of the Act. The factors referred to in section 108(d)(1) are:

- The "effectiveness of the Program;"
- The "likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program" and
- The "availability and affordability of such insurance for various policyholders, including railroads, trucking, and public transit."

Pursuant to the Act, Treasury is now considering whether to extend the make available requirements in section 103(c)(1)(A) and (B) to Program Year 3. As noted above, section 103(c)(2) provides that Treasury base this determination "on the factors referred to in section 108(d)(1)". Section 108(d) of the Act requires Treasury to conduct a study and prepare a report to Congress by June 30, 2005 relating to the termination of the Program; the factors described in section 108(d)(1) (and cross-referenced by section 103 of the Act) are keyed directly to the overall effectiveness of the Program and how the insurance industry might respond after the termination of the Program. To better enable Treasury to evaluate the overall effectiveness of the Act as required by section 108(d), Treasury is in the process of conducting a series of nationally representative surveys of insurers and policyholders.

The section 103(c) determination of whether to extend the make available requirements, and its timing, differ from the purpose and timing of the study and report required by section 108(d), but the Act requires Treasury to base the make available determination on the factors referenced in section 108(d)(1).

[1] Following enactment of the Act, Treasury promptly issued interim guidance on the make available requirement and other provisions of the Act. See for example, 67 FR 76206 (December 11, 2002). This interim guidance was superceded by Treasury's interim final rules and notice and comment rulemaking. Treasury's final regulations implementing the make available requirements of section 103(c)(1) are located at 31 CFR 50.20-24. See also 68 FR 59720 (October 17, 2003).

Treasury's data collection from the surveys we are conducting as part of our overall evaluation of the Program for purposes of the study under section 108(d) will only be partially complete by the time a decision on extending the make available requirement must be made. In addition, the make available requirement of section 103(c) comprises only one component of the overall Program. Thus, as Treasury considers whether to extend the make available requirement into Program Year 3, we are particularly interested in any specific way, or ways, in which the make available requirement has worked or affected the overall operation of the Program and whether this ties into the factors described in section 108(d)(1).

To facilitate a determination by Treasury within the required time frame on whether to extend the make available requirement into Program Year 3, Treasury solicits general comments from the public as well as specific responses to the following questions, including submission of any relevant empirical data in support of such comments where appropriate and available.

I. Effectiveness of the Make Available Requirement in the Context of the Overall Program

1.1 Has the make available requirement contributed to the overall effectiveness of the Program over the first two years of the Program? In particular, has the make available requirement been effective in making terrorism insurance coverage available and more affordable to the insurance marketplace in general, to large corporate policyholders, and to small business policyholders? (We specifically seek information on terrorism coverage for railroads, trucking and public transit in response to this question.)

1.2 How would the effectiveness of the Program be affected during Program Year 3 (where the federal backstop for terrorism insurance is still maintained under the Act) if the make available requirement is not extended? Would policyholders still be able to obtain terrorism risk insurance (under what terms and conditions) and would the affordability be impacted if the requirement is not extended? Compare your response to the preceding questions to what you believe would be the effectiveness of the Program if the make available requirement is extended into 2005.

1.3 Has Treasury's implementation of the make available requirement contributed to the effectiveness of the Program? In particular, has the make available requirement resulted in businesses being provided with useful information and the enhanced ability to compare prices for terrorism risk insurance across a number of providers? Given the experience with the make available requirement since enactment and policyholders' decisions on whether to purchase coverage provided by the Act, are there other approaches to implementing the make available requirement that are worth considering?

1.4 How would a decision on extending or not extending the make available requirement affect policyholders' understanding of their options regarding the availability of terrorism risk insurance coverage in Program Year 3 (e.g., that the federal backstop for terrorism risk insurance is still in force)? Would one course of action be better understood by policyholders than other options?

II. The Relationship Between the Make Available Requirement and the Likely Capacity of Property and Casualty Insurers to Offer Coverage for Terrorism Risk After Termination of the Program

2.1 What is the relationship between the make available requirement and an insurer's capacity to offer terrorism risk insurance coverage? How has the make available requirement affected or interacted with the available capacity of property and casualty insurers to provide terrorism risk insurance coverage during the course of the Program to date? Has the make available requirement led to any build-up in capacity?

2.2. How would a Treasury decision to extend or not to extend the make available requirement affect or interact with the capacity of property and casualty insurers (including the availability of reinsurance) in terms of offering terrorism risk insurance coverage in Program Year 3? In addition, would there be any effect on insurers' decision to offer terrorism risk insurance coverage beyond 2005 that could be associated with a decision to extend or not to extend the make available requirement during Program Year 3?

III. Operational Issues

3.1 What would be the regulatory impact at the state level (e.g. on filings with the state regulator of policy forms or exclusions) if the make available requirement were extended through Program Year 3 (2005)? Similarly, what would be the regulatory impact at the state level if the make available requirement were not extended through Program Year 3?

3.2 Are there other operational issues that Treasury should consider as part of determining whether or not to extend the make available requirement through Program Year 3?

Dated:

Wayne A. Abernathy

Assistant Secretary for Financial Institutions

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

April 30, 2004
JS-1496

Treasury Department Announces Proposed Regulation Implementing the Litigation Management Provisions of the Terrorism Risk Insurance Act

The Treasury Department today announced a proposed regulation under the Terrorism Risk Insurance Act (TRIA) of 2002, which was signed into law by President Bush on November 26, 2002.

The proposed regulation being released today implements the litigation management provisions of TRIA and President Bush's directive that Treasury propose regulations providing procedures for advance Treasury review and approval of settlements related to covered losses under the Program. The regulation is designed to protect taxpayer resources by ensuring that claims made under the program are bona fide, as well as to facilitate expedited compensation for legitimate losses covered under the Act. Interested parties will have the opportunity to submit formal comments on the regulation, and the comment period will last for 60 days from the date of the regulation's publication in the Federal Register.

This proposed regulation and other information related to the Terrorism Risk Insurance Program can be found at http://www.treasury.gov/trip/.

REPORTS

- Notice of Proposed Rulemaking

DEPARTMENT OF THE TREASURY

Departmental Offices

31 CFR Part 50

RIN 1505-AB08

Terrorism Risk Insurance Program; Litigation Management

AGENCY: Departmental Offices, Treasury

ACTION: Notice of Proposed Rulemaking

SUMMARY: The Department of the Treasury (Treasury) is issuing this proposed rule as part of its implementation of Title I of the Terrorism Risk Insurance Act of 2002 (Act). That Act established a temporary Terrorism Insurance Program (Program) under which the Federal Government will share the risk of insured loss from certified acts of terrorism with commercial property and casualty insurers until the Program ends on December 31, 2005. This notice of proposed rulemaking proposes regulations concerning litigation management related to insured losses under the Program. This proposed rule is the fifth in a series of regulations that Treasury is issuing to implement the Program.

DATES: Written comments may be submitted on or before [INSERT DATE THAT IS 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Submit comments (if hard copy, preferably an original and two copies) to the Terrorism Risk Insurance Program, Attention: Terrorism Risk Insurance Program Public Comment Record, Room 2100, 1425 New York Avenue, N.W., Washington, D.C. 20220. Because paper mail in the Washington, D.C., area may be subject to delay, it is recommended that comments be submitted electronically to: triacomments@do.treas.gov. All comments should be captioned with "[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER] NPRM TRIA Comments." Please include your name, affiliation, address, e-mail address, and telephone number in your comment. Comments may also be submitted through the Federal eRulemaking Portal: http://www. regulations.gov. Comments will be available for public inspection by appointment only at the Reading Room of the Treasury Library. To make appointments, call (202) 622-0990 (not a toll-free number).

FOR FURTHER INFORMATION CONTACT: David Brummond, Legal Counsel, or C. Christopher Ledoux, Senior Attorney, Terrorism Risk Insurance Program, (202) 622-6770 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

I. Background

A. Terrorism Risk Insurance Act of 2002

On November 26, 2002, the President signed into law the Terrorism Risk Insurance Act of 2002 (Public Law 107-297, 116 Stat. 2322). The Act was effective immediately. The Act's purposes are to address market disruptions, ensure the continued widespread availability and affordability of commercial property and casualty insurance for terrorism risk, and to allow for a transition period for the private markets to stabilize and build capacity while preserving State insurance regulation and consumer protections.

Title I of the Act establishes a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from an act of terrorism, which as defined in the Act is certified by the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General. The Act authorizes Treasury to administer and implement the Terrorism Risk Insurance Program, including the issuance of regulations and procedures. The Program will end on December 31, 2005. Thereafter, the Act provides Treasury with certain continuing authority to take actions as necessary to ensure payment, recoupment, adjustments of compensation and reimbursement for insured losses arising out of any act of terrorism (as defined under the Act) occurring during the period between November 26, 2002, and December 31, 2005.

Each entity that meets the definition of "insurer" (well over 2000 firms) must participate in the Program. The amount of federal payment for an insured loss resulting from an act of terrorism is to be determined based upon insurance company deductibles and excess loss sharing with the Federal Government, as specified by the Act and the implementing regulations. An insurer's deductible increases each year of the Program, thereby reducing the Federal Government's share prior to expiration of the Program. An insurer's deductible is calculated based on a percentage of the value of direct earned premiums collected over certain statutory periods. Once an insurer has met its individual deductible, the federal payments cover 90 percent of insured losses above the deductible, subject to an annual industry-aggregate limit of $100 billion.

The Program provides a federal reinsurance backstop for three years. The Act provides Treasury with authority to recoup federal payments made under the Program through policyholder surcharges, up to a maximum annual limit. The Act also prohibits duplicative payments for insured losses that have been covered under any other federal program.

The mandatory availability or "make available" provisions in section 103(c) of the Act require that, for Program Year 1, Program Year 2, and, if so determined by the

Secretary of the Treasury, for Program Year 3, all entities that meet the definition of insurer under the Program must make available in all of their property and casualty insurance policies coverage for insured losses resulting from an act of terrorism. This coverage cannot differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism. The Secretary of the Treasury may determine, not later than September 1, 2004, to extend the make available requirements through Program Year 3, based on factors referenced in section 108(d)(1) of the Act. Regardless of whether the make available requirements of section 103 are extended, the Program and the Act's federal backstop for insured losses resulting from acts of terrorism continue through December 31, 2005.

As conditions for federal payment under the Program, insurers must provide clear and conspicuous disclosure to the policyholders of the premium charged for insured losses covered by the Program and the Federal share of compensation for insured losses under the Program. In addition, the Act requires that insurers submit claims and make certain certifications to Treasury. Treasury has recently published in the *Federal Register* a proposed rule concerning claims regulations for the Program. *See* 68 FR 67100 (Dec. 1, 2003).

The Act also contains specific provisions designed to manage litigation arising out of or resulting from a certified act of terrorism. Among other provisions, section 107 creates, upon certification of an act of terrorism by the Secretary, an exclusive Federal cause of action and remedy for property damage, personal injury, or death arising out of or relating to an act of terrorism; preempts certain State causes of action; provides for consolidation of all civil actions in Federal court for any claim (including any claim for loss of property, personal injury, or death) relating to or arising out of an act of terrorism; and provides that amounts awarded in actions for property damage, personal injury, or death that are attributable to punitive damages are not to be counted as "insured losses" and not paid under the Program. The Act also provides the United States with the right of subrogation with respect to any payment or claim paid by the United States under the Program. In this rulemaking, Treasury is proposing to implement these provisions of the Act to the extent that regulations are necessary for administration of the Program or involve the Federal share of compensation under the Program. This proposed regulation addresses the advance approval of proposed settlements of causes of action described in section 107 of the Act, as directed by the President in a *Memorandum to the Secretary of the Treasury. See* 38 WEEKLY COMP. PRES. DOC. 2096 (Nov. 25, 2002)(also accessible at www.treasury.gov/trip).

In implementing the Program, Treasury is guided by several goals. First, Treasury strives to implement the Act in a transparent and effective manner that treats comparably those insurers required to participate in the Program and provides necessary information to policyholders in a useful and efficient manner. Second, in accord with the Act's stated purposes, Treasury seeks to rely as much as possible on the State insurance regulatory structure. In that regard, Treasury has coordinated the implementation of all aspects of the Program with the National Association of Insurance Commissioners (NAIC). Third, to the extent possible within statutory constraints, Treasury seeks to allow insurers to participate in the Program in a manner consistent with procedures used in their normal course of business. Finally, given the temporary and transitional nature of the Program, Treasury is guided by the Act's goal that insurers develop their own capacity, resources, and mechanisms for terrorism insurance coverage when the Program expires.

B. Previously Issued Interim Guidance and Regulations

To assist insurers, policyholders, and other interested parties in complying with immediately applicable requirements of the Act prior to the issuance of regulations, Treasury issued interim guidance in four separate notices, on December 3 and 18, 2002 and on January 22 and March 25, 2003. The interim guidance addressed issues requiring clarification to immediately applicable provisions. The guidance was to be relied upon by insurers until superseded by regulations or a subsequent notice.

Treasury's first notice of Interim Guidance was published in the *Federal Register* at 67 FR 76206 on December 11, 2002, and addressed, among other matters, statutory disclosure obligations of insurers as conditions for federal payment under the Program; the requirement that an insurer "make available" terrorism insurance; and how insurers were to calculate the "direct earned premium" received from commercial lines of property and casualty insurance as well as their "insurer deductibles" for purposes of the Program.

Treasury's second notice of interim guidance was published at 67 FR 78864 on December 26, 2002. The Interim Guidance addressed the statutory categories of "insurers" that are required to participate in the Program, including their "affiliates"; provided clarification on the scope of insured losses covered by the Program; and provided additional guidance to enable eligible surplus line carriers listed on the NAIC Quarterly Listing of Alien Insurers or Federally approved insurers to calculate their insurer deductibles for purposes of the Program. This was followed by Treasury's third notice of interim guidance, which was published at 68 FR 4544 on January 29, 2003, and further clarified certain disclosure and certification requirements, and addressed issues concerning non-U.S. insurers, and the scope of the term "insured loss" under the Act.[1]

On February 28, 2003 (68 FR 9804) Treasury published an interim final rule together with a proposed rule addressing the scope of the program, key definitions and

[1] Treasury's fourth interim guidance, published at 68 FR 15039 on March 27, 2003, provided insurers a procedure by which they could seek to rebut a presumption of control established in Treasury's first set of interim final regulations. The Interim Guidance has subsequently been superseded by a provision in the final rule for Subpart A of Part 50, Title 31 published at 68 FR 41250 (July 11, 2003).

certain general provisions to lay the groundwork for program implementation. This interim final rule was finalized and published in the *Federal Register* at 68 FR 41250 (July 11, 2003) (as amended at 68 FR 48280 (Aug. 13, 2003)) and created Subpart A of Part 50 in Title 31 of the Code of Federal Regulations. Treasury's second regulation created Subparts B and C of Part 50 as an interim final rule published in the *Federal Register* at 68 FR 19301 (Apr. 18, 2003) and was finalized and published at 68 FR 59720 (Oct. 17, 2003). These regulations address disclosures that insurers must make to policyholders as a condition for federal payment under the Act, and requirements that insurers make available, in their commercial property and casualty insurance policies, terrorism risk coverage for insured losses under the Program.

Treasury also created a Subpart D to Part 50 of Title 31, which was first proposed and published in the *Federal Register* at 68 FR 19309 (Apr. 18, 2003) and finalized and published at 68 FR 59715 (Oct. 17, 2003). This regulation applies the provisions of the Act to State residual market insurance entities and State workers' compensation funds.

Most recently, Treasury published a proposed rule in the *Federal Register* at 68 FR 67100 (December 1, 2003) that adds Subparts F and G to Part 50 of Title 31. Subpart F establishes procedures for filing claims for payment of the Federal share of compensation for insured losses. Subpart G addresses information to be retained related to the handling and settlement of claims to enable Treasury to perform financial and claim audits.

II. The Proposed Rule

A. Overview

The rule proposed in this notice would create Subpart I of Part 50 in Title 31 of the Code of Federal Regulations. It would implement the litigation management provisions in section 107 of the Act, provide for advance approval of settlements of certain causes of action, and clarify related aspects of the Program. Upon certification of an act of terrorism by the Secretary, section 107 creates a Federal cause of action for property damage, personal injury, or death arising out of or resulting from the act of terrorism, which is the exclusive cause of action and remedy for such losses. In addition, section 107 provides that:

- all State causes of action of any kind for property damage, personal injury, or death arising out of or resulting from an act of terrorism that are otherwise available under State law are preempted;

- civil actions are to be consolidated in a Federal district court or courts, as designated by the Judicial Panel on Multidistrict Litigation, which shall have original and exclusive jurisdiction over all actions for any claim (including any claim for loss of property, personal injury, or death) relating to or arising out of an act of terrorism;

- the substantive law for decision in such actions shall be derived from the law, including choice of law principles, of the State in which the act of terrorism occurred, unless such law is otherwise inconsistent with or preempted by Federal law;

- any amounts awarded in any action for property damage, personal injury, or death under section 107 that are attributable to punitive damages shall not count as "insured losses" for purposes of the Program;

- contractual arbitration rights are preserved; and

- the United States has a right of subrogation with respect to any payment or claim paid pursuant to the Act.

In connection with the implementation of the litigation management provisions of the Act, the President directed the Secretary to use his authority under the Act to require insurers to obtain Treasury's advance approval before settling certain causes of action described in section 107 of the Act. The following discussion includes a section-by-section analysis of these proposed regulatory provisions.

B. Exclusive Federal Cause of Action and Remedy (Section 50.80)

Section 107(a)(1) of the Act states that once the Secretary has certified that an act of terrorism has occurred pursuant to section 102 of the Act, there shall exist a Federal cause of action for property damage, personal injury, or death arising out of or resulting from such act of terrorism. The Federal cause of action shall be the exclusive cause of action and remedy for claims for property damage, personal injury, or death arising out of or relating to such act of terrorism, except as provided in section 107(b) of the Act, as discussed further below. The exclusive Federal cause of action created by the Act applies to *all* actions for property damage, personal injury, or death arising out of or resulting from a certified act of terrorism, regardless of whether the cause of action involves an insured loss covered by commercial property and casualty insurance. Section 50.80(a) of the proposed rule follows this provision of the Act.

Section 107(b) of the Act creates an exception to the exclusive Federal cause of action and remedy established in section 107(a) by stating that nothing in the litigation management provisions of section 107 shall in any way limit the liability of any government, organization, or person who knowingly participates in, conspires to commit, aids and abets, or commits any act of terrorism certified as such under the Act. The proposed rule reflects this exception.

Section 107(e) of the Act provides that section 107 applies only to actions for property damage, personal injury, or death that arise out of or result from acts of terrorism that occur or occurred during the effective period of the Program. Under the Act, the Program terminates on December 31, 2005 (*see* section 108(a) of the Act); therefore the proposed rule provides that the exclusive cause of action and remedy exists only for those causes of action that arise out of or result from certified acts of terrorism that occur through December 31, 2005.

Finally, section 107(d) of the Act provides that section 107 shall not be construed to affect (1) any party's contractual right to arbitrate a dispute; or (2) any provision of the Air Transportation Safety and System Stabilization Act (Public Law 107-42; 49 U.S.C. 40101 note). Section 50.80(c) of the proposed rule follows the provisions of the Act.

C. Preemption of State Causes of Action (Section 50.81)

The Act preempts all State causes of action for property damage, personal injury, or death arising out of or resulting from an act of terrorism that are otherwise available under State law, except as provided in section 107(b). *See* section 107(a)(2) of the Act. Section 50.81 of the proposed rule reflects this statutory preemption and includes the circumstances where the Act does not limit liability (*i.e.,* for causes of action against any government, organization, or person who knowingly participates in, conspires to commit, aids and abets, or commits any act of terrorism.)

Treasury recognizes that the Act's preemption of State causes of action for personal injury or death raises a question regarding the treatment of workers' compensation claims under section 107. It is Treasury's view that section 107(a)(2) of the Act does not preempt workers' compensation claims involving personal injury or death on the basis that workers' compensation claims are not "causes of action" for personal injury or death within the meaning of section 107. A "cause of action" is a group of operative facts giving rise to one or more bases for one person to sue and obtain a remedy in court from another person.[2] As a general matter, the laws of the various States have eliminated "causes of action" for work-related injuries and replaced them with various types of workers' compensation systems; therefore, there are no "causes of action . . . otherwise available under State law" for work related injuries within the meaning of section 107(a)(2). Thus, it is Treasury's view that the preemption provision in section 107(a)(2) does not extend to workers' compensation systems in the various States.

[2] *See* BLACK'S LAW DICTIONARY 214 (7th ed. 1999).

D. Program Procedures for Notifying Federal Court

Section 107(a)(4) of the Act provides that for each act of terrorism certified by the Secretary pursuant to section 102 of the Act, the Judicial Panel on Multidistrict Litigation shall designate one district court or, if necessary, multiple district courts of the United States that shall have original and exclusive jurisdiction over all actions for any claim (including any claim for loss of property, personal injury, or death) relating to or arising out of an act of terrorism.

The Act also provides that the Judicial Panel on Multidistrict Litigation is to designate the district court or courts not later than 90 days after the occurrence of an act of terrorism. However, it is the Secretary's certification of an act of terrorism that triggers the creation of the exclusive Federal cause of action and the need for the Judicial Panel to designate a district court for the consolidation of actions. Therefore, to facilitate administration of the Program, Treasury intends to notify the Panel as soon as practicable following any certification of an act of terrorism. In this regard, Treasury is considering the appropriate operational procedures that it would follow once an act of terrorism is certified by the Secretary. Treasury invites comments on such procedures from all interested parties.

E. Failure to Litigate in Federal Court Pursuant to the Act

In applying section 107(a)(4) of the Act specifically to the Program, Treasury is considering whether it is appropriate or necessary to include in Part 50 a rule providing that any amounts awarded in any civil action relating to or arising out of an act of terrorism that are not awarded by the district court or district courts designated by the Judicial Panel on Multidistrict Litigation shall be ineligible for compensation, regardless of whether the amounts awarded are insured losses covered by commercial property and casualty insurance issued by an insurer. Treasury solicits public comment on such a provision from all interested parties.

F. Treasury's Advance Approval of Settlements (Section 50.82)

On November 26, 2002, upon signing the Terrorism Risk Insurance Act of 2002, the President issued a *Memorandum to the Secretary of the Treasury* that directed the Secretary to propose a rule requiring insurers to obtain the advance approval of Treasury of any proposed settlements of causes of action described in section 107 of the Act arising out of or resulting from an act of terrorism. 38 WEEKLY COMP. PRES. DOC. 2096 (Nov. 25, 2002) (also accessible at www.treasury.gov/trip).

The Act authorizes Treasury to administer the Program, investigate and audit claims, and pay the Federal share of compensation for insured losses. (*see* section 104(a) of the Act). In addition, under section 103(b)(3) of the Act, Treasury is authorized to prescribe reasonable procedures concerning insurers' processing of claims for insured losses, which become conditions for federal payment. Pursuant to its administrative authority under the Act and to protect the interests of the United States, the proposed rule requires advance approval by Treasury of proposed settlements of certain causes of action described in section 107, to the extent liability for such causes of action is covered by or paid, in whole or in part, by an insurer pursuant to coverage for insured losses under the Program, provided that the insurer intends to submit the settlement as part of its claim for federal payment under the Program.

1. Pre-Approval of Certain Proposed Settlements

Under section 104(a)(2), the Secretary is authorized to prescribe regulations to administer and implement the Program effectively. Treasury believes that establishing monetary thresholds below which an insurer is not required to seek pre-approval by Treasury of settlements balances the need to protect the interests of the United States with the administrative costs involved in the advance approval of settlements. Treasury invites comments on these thresholds (which are explained in more detail below) from all interested parties.

Treasury's proposed rule would require an insurer to seek Treasury's advance, written approval where an insurer (directly or through its insured) intends to settle a Federal cause of action involving third-party liability claims (by a third party against an insured and/or the insurer) for property damage, personal injury, or death arising out of or resulting from an act of terrorism when:

- any portion of the proposed settlement amount that is attributable to liability for personal injury or death is $1 million or more, or that is attributable to liability for property damage (including loss of use) is $5 million or more, regardless of the number of third-party liability claims being settled; and

- all or part of the settlement amount is expected to be part of the insurer's claim for federal payment under the Program (included in the insurer's aggregate insured losses). No approval is required if the insurer does not intend to and does not submit all or part of the settlement as part of its claim for federal payment of insured losses under the Program.

Treasury notes that its proposed settlement approval requirement applies to Federal causes of action described above regardless of whether a lawsuit has actually been filed or an arbitration commenced with respect to the matter.

Treasury also notes that settlements that are not required to be submitted for prior approval are still subject to Treasury review, like any other claim, at the point of claim submission by the insurer or at the time of any audit (*see* Subparts F and G proposed as part of claims and audit rulemakings, 68 FR 67100 (Dec. 1, 2003).

Treasury views this prior approval requirement as extending to settlements for insured losses arising from third-party claims for property damage, personal injury or death against a commercial insured. Most commercial liability policies provide coverage for the insured's defense of such action. In this regard, the insurer is usually involved in the settlements of litigated third-party property and casualty claims. Through the insurer, Treasury will have final settlement approval authority.

Coverage disputes and other civil actions involving contract rights are not included in the scope of the civil actions requiring advanced settlement approval by Treasury. Such disputes involve causes of action that are based on contract law, not on property damage, personal injury, or death and are not subject to prior approval by Treasury.

Treasury seeks comments on how frequently claims are received by commercial property and casualty insurers under commercial liability policies where the insured settles directly with a claimant and then notifies the insurer after the settlement has been consummated. In this situation, if the insurer was not promptly notified in advance of the settlement, the insurer may have difficulty meeting the requirement to obtain prior approval from Treasury of the proposed settlement, jeopardizing the application of federal reinsurance under the Program. Treasury invites public comments on the frequency of such situations, the size of claims usually involved, and possible approaches to address these situations.

2. Factors to be Reviewed by Treasury

In determining whether to approve a proposed settlement, and in keeping with its obligation to safeguard the use of taxpayer resources, Treasury will consider the nature of the insured loss, the facts and circumstances surrounding the loss, and other factors such as whether:

- the proposed settlement compensates for a *bona fide* loss that is an insured loss under the terms and conditions of the underlying commercial property and casualty insurance policy;

- any amount of the proposed settlement is attributable to punitive or exemplary damages intended to punish or deter (whether or not specifically so described as such damages);

- the settlement amount offsets amounts received from the United States pursuant to any other Federal program;

- attorneys' fees and expenses in connection with the settlement are unreasonable or inappropriate, in whole or in part and whether they have caused the insured losses under the underlying commercial property and casualty insurance policy to be overstated; and

- any other criteria that Treasury may consider appropriate, depending on the facts and circumstances surrounding the settlement, including the information contained in section 50.83.

Additionally, Treasury will review any proposed settlement in accordance with proposed section 50.50 of Subpart F, including whether:

- the settlement was fraudulent, collusive, in bad faith, or otherwise dishonest; and
- the insurer took all businesslike steps reasonably necessary to properly and carefully investigate and ascertain the amount of the loss consistent with appropriate business practices.

3. *Settlement Without Treasury's Approval*

If an insurer settles a cause of action after Treasury has rejected the proposed settlement, or if an insurer settles a cause of action without seeking Treasury's approval in advance, as required by section 50.82, the insurer will not be entitled to the Federal share of the amount paid as part of its claim for federal payment unless the insurer can demonstrate, to the satisfaction of the Treasury, extenuating circumstances. Also, the insurer shall not be entitled to include the paid settlement amount as an insured loss in its aggregate insured losses (whether or not those aggregate insured losses exceed the insurer deductible) for purposes of calculating the Federal share of compensation due to the insurer under the Program. Treasury is proposing to make advance approval of certain settlements a condition for federal payment under the Program, unless the insurer demonstrates, to the satisfaction of the Treasury, that extenuating circumstances prevented the insurer from seeking Treasury's advance approval.

4. *Ensuring that Punitive Damages are Not Compensated for Under the Program.*

Section 107(a)(5) of the Act provides that any amounts awarded in actions under section 107(a)(1) of the Act (exclusive Federal cause of action for property damage, personal injury, or death arising out of or resulting from an act of terrorism) that are attributable to punitive damages shall not count as insured losses under the Act. Punitive damages, sometimes also referred to as exemplary damages, are damages that are not compensatory in nature but are an award of money made to a claimant solely to punish or deter a wrongdoer. Because section 107(a)(5) of the Act does not consider punitive damages as "insured losses" under the Act, the Federal Government will not compensate an insurer for such damages. Accordingly, Treasury has proposed amending section 50.5

of Subpart A (as part of another proposed rulemaking recently published in the *Federal Register*) and amending the definition of "insured loss" specifically to exclude punitive or exemplary damages as compensable under the Program.

Consistent with the proposed claims procedures rule, a factor Treasury will consider in approving a proposed settlement is whether the settlement excludes punitive damages, regardless of how the parties to the settlement agreement characterize the payment. An insurer shall be required to identify any portion of a proposed settlement amount that is attributable to punitive damages, or that intends to compromise a claim or demand for punitive damages in a cause of action for which punitive damages could be awarded. Treasury will review proposed settlements to determine whether all or part of the settlement amount is intended to compromise an actual or threatened claim for punitive or exemplary damages, even if the settlement does not indicate that the payment includes punitive or exemplary damages.

5. Evaluating Attorneys' Fees and Expenses

One of the factors Treasury will take into account in reviewing proposed settlements is the amount of attorneys' fees and other legal expenses. In evaluating the appropriateness of attorneys' fees and expenses that are part of any proposed settlement, Treasury intends to consider such factors as those weighed by Federal courts regarding the reasonableness of attorneys' fees under applicable law. Among the factors Treasury may consider are the time and labor required; the novelty and difficulty of the questions; the skill requisite to perform the legal service properly; the customary fee; whether the fee is fixed or contingent; the amount involved and results obtained; the experience, reputation, and the ability of the attorneys; and awards in similar cases. In addition, Treasury will determine whether the attorneys' fees in question have caused the insured losses under the underlying commercial property and casualty insurance policy to be overstated.

G. Procedures for Requesting Approval of Settlements (Section 50.83)

Section 50.83 of the proposed rule establishes a procedure for an insurer to submit proposed settlements for advance approval by Treasury. Generally, within 30 days after Treasury's receipt of a complete notice of the proposed settlement and an insurer's request that the proposed settlement be approved, Treasury may issue a written response and either approve or disapprove the proposed settlement, in whole or in part. If Treasury does not issue a written response within 30 days after its receipt of a complete notice (or within the time as extended in writing by Treasury), the request for advance approval of the settlement will be deemed approved under section 50.83. (The settlement will still be subject to review under the claims procedures.) The proposed rule also outlines the minimum information Treasury believes may be relevant and useful in considering whether to approve a proposed settlement. Treasury invites public comment concerning this settlement approval request process.

H. Right of Subrogation (Section 50.84)

Section 107(c) of the Act provides that the United States shall have the right of subrogation with respect to any payment or claim paid by the United States under the Act. In most commercial insurance policies, insurance companies become subrogated to the rights of the persons they pay, to the extent of payment. In section 50.85, Treasury proposes to require insurers to take steps to preserve rights of subrogation under section 107(c).

III. Procedural Requirements

Executive Order 12866, "Regulatory Planning and Review". This proposed rule is a significant regulatory action for purposes of Executive Order 12866, "Regulatory Planning and Review," and has been reviewed by the Office of Management and Budget.

Regulatory Flexibility Act. Pursuant to the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.*, it is hereby certified that this proposed rule will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The proposed rule establishes requirements for advance approval of settlements when claims are to be submitted for insured losses. There is no impact on small insurers unless an act of terrorism occurs and federal compensation is sought by small insurers entitled to reimbursement for their insured losses. If an act of terrorism occurs and federal payment is sought through a claim, the proposed rule's impact on small insurers is likely to be minimal because most of the information that would have to be submitted in connection with Treasury approval of settlements largely duplicates information already contained in an insurer claim file or an attorney case file. Moreover, the $1 million and $5 million thresholds for the submission of settlements to Treasury for approval is likely further to minimize burdens on small insurers.

Paperwork Reduction Act. The collection of information contained in this proposed rule has been submitted to the Office of Management and Budget (OMB) for review under the requirements of the Paperwork Reduction Act, 44 U.S.C. 3507(d). 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 OMB.

Organizations and individuals desiring to submit comments concerning the collection of information in the proposed rule should direct them to the Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, D.C. 20503 (preferably by FAX to 202-395-6974, or by email to jlackeyj@omb.eop.gov). A copy of the comments should also be sent to Treasury at the following address: Terrorism Risk Insurance Program, Attention: Terrorism Risk Insurance Program Public Comment Record, Room 2100, 1425 New

York Avenue, N.W., Washington, D.C. 20220 and electronically to: triacomments@do.treas.gov. Comments on the collection of information should be received by [INSERT 30 DAYS AFTER PUBLICATION].

Treasury specifically invites comments on: (a) whether the proposed collection of information is necessary for the proper performance of the mission of Treasury and whether the information will have practical utility; (b) the accuracy of the estimate of the burden of the collections of information (see below); (c) ways to enhance the quality, utility, and clarity of the information collection; (d) ways to minimize the burden of the information collection, including through the use of automated collection techniques or other forms of information technology; and (e) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to maintain the information.

The collection of information in the proposed rule is the information required in connection with requests for Treasury approval of proposed settlements in § 50.83. The submission of specified information in connection with a proposed settlement is mandatory for any insurer that seeks payment of a Federal share of compensation.

If an act of terrorism is certified under the Act, the number of settlements, if any, will be determined by the size and nature of the certified act of terrorism. Because of the extreme uncertainty regarding any such event, a "best estimate" has been developed based on the considered judgment of Treasury. This estimate has 100 insurers sustaining insured losses; each of these insurers would process an average of 100 underlying claims for a total of 10,000 claims. If one in five claims involves amounts in dispute that exceed the monetary thresholds in § 50.82(a), there would be 2,000 claims eligible for settlement. If 90 percent of these claims settle before any judgment or award, this would require 1,800 claims to be submitted to Treasury for advance approval under Subpart I.

The information required by Treasury in connection with a request for advanced approval of a proposed settlement in § 50.83 largely duplicates information already contained in an insurer claim file or an attorney case file. The burden associated with compiling and submitting such information to Treasury is therefore relatively moderate. Accordingly, Treasury estimates that the proposed rule will impose 5 hours of burden with respect to each claim. The estimated annual burden of the proposed rule is therefore 9,000 hours.

List of Subjects in 31 CFR Part 50

Terrorism risk insurance.

Authority and Issuance

For the reasons set forth above, 31 CFR part 50 is proposed to be amended as follows:

PART 50 – TERRORISM RISK INSURANCE PROGRAM

1. The authority citation for part 50 continues to read as follows:

Authority: 5 U.S.C. 301; 31 U.S.C. 321; Title I, Pub. L. 107-297, 116 Stat. 2322 (15 U.S.C. 6701 note).

2. Subpart I of part 50 is proposed to be added to read as follows:

SUBPART I – FEDERAL CAUSE OF ACTION; APPROVAL OF SETTLEMENTS

§ 50.80 Federal Cause of Action and Remedy.

(a) *General.* Upon certification of an act of terrorism pursuant to section 102 of the Act, there shall exist a Federal cause of action for property damage, personal injury, or death arising out of or resulting from such act of terrorism, pursuant to section 107 of the Act, which shall be the exclusive cause of action and remedy for claims for property damage, personal injury, or death arising out of or relating to such act of terrorism, except as provided in paragraph (c) of this section.

(b) *Effective period.* The exclusive Federal cause of action and remedy described in paragraph (a) of this section shall exist only for causes of action for property damage, personal injury, or death that arise out of or result from acts of terrorism that occur or occurred during the effective period of the Program as set forth in section 108 of the Act.

(c) *Rights not affected.* Nothing in section 107 of the Act or this Subpart shall in any way:

(1) Limit the liability of any government, organization, or person who knowingly participates in, conspires to commit, aids and abets, or commits any act of terrorism;

(2) Affect any party's contractual right to arbitrate a dispute; or

(3) Affect any provision of the Air Transportation Safety and System Stabilization Act (Public Law 107-42; 49 U.S.C. 40101 note).

§ 50.81 State Causes of Action Preempted.

Upon certification of an act of terrorism pursuant to section 102 of the Act, all State causes of action of any kind for property damage, personal injury, or death arising out of or resulting from such act of terrorism that are otherwise available under State law are preempted, except that, pursuant to section 107(b) of the Act, nothing in this section shall limit in any way the liability of any government, organization, or person who knowingly participates in, conspires to commit, aids and abets, or commits the act of terrorism certified by the Secretary.

§ 50.82 Advance Approval of Settlements.

(a) *General.* An insurer shall submit to Treasury for advance approval any proposed agreement to settle or compromise any Federal cause of action for property damage, personal injury, or death, including any agreement between its insured(s) and third parties, involving an insured loss, all or part of the payment of which the insurer intends to submit as part of its claim for Federal payment under the Program, when:

(1) Any portion of the proposed settlement amount that is attributable to an insured loss or losses involving personal injury or death in the aggregate is $1 million or more, regardless of the number of causes of action or insured losses being settled; or

(2) Any portion of the proposed settlement amount that is attributable to an insured loss or losses involving property damage (including loss of use) in the aggregate is $5 million or more, regardless of the number of causes of action or insured losses being settled.

(b) *Factors.* In determining whether to approve a proposed settlement in advance, Treasury will consider the nature of the loss, the facts and circumstances surrounding the loss, and other factors such as whether:

(1) The proposed settlement compensates for a loss that is an insured loss under the terms and conditions of the underlying commercial property and casualty insurance policy;

(2) Any amount of the proposed settlement is attributable to punitive or exemplary damages intended to punish or deter (whether or not specifically so described as such damages);

(3) The settlement amount offsets amounts received from the United States pursuant to any other Federal program;

(4) The settlement does not involve unreasonable or inappropriate attorneys' fees and legal expenses and whether they have caused the insured losses under the underlying commercial property and casualty insurance policy to be overstated; and

(5) Any other criteria that Treasury may consider appropriate, depending on the facts and circumstances surrounding the settlement, including the information contained in §50.83.

(c) *Settlement Without Seeking Advance Approval or Despite Disapproval.* If an insurer settles a cause of action or agrees to the settlement of a cause of action without submitting the proposed settlement for Treasury's advance approval in accordance with this section and in accordance with §50.83 or despite Treasury's disapproval of the proposed settlement, the insurer will not be entitled to include the paid settlement amount (or portion of the settlement amount, to the extent partially disapproved) in its aggregate insured losses for purposes of calculating the Federal share of compensation of its insured losses, unless the insurer can demonstrate, to the satisfaction of Treasury, extenuating circumstances.

§ 50.83 Procedure for Requesting Approval of Proposed Settlements.

(a) *Submission of Notice.* Insurers must request advance approval of a proposed settlement by submitting a notice of the proposed settlement and other required information in writing to the Terrorism Risk Insurance Program Office or its designated representative. The address where notices are to be submitted will be available at *http://www.treasury.gov/trip* following any certification of an act of terrorism pursuant to section 102(1) of the Act.

(b) *Complete Notice.* Treasury will review requests for advance approval and determine whether additional information is needed to complete the notice.

(c) *Treasury Response or Deemed Approval.* Within 30 days after Treasury's receipt of a complete notice, or as extended in writing by Treasury, Treasury may issue a written response and indicate its partial or full approval or rejection of the proposed settlement. If Treasury does not issue a response within 30 days after Treasury's receipt of a complete notice, unless extended in writing by Treasury, the request for advance approval is deemed approved by Treasury. Any settlement is still subject to review under the claim procedures pursuant to § 50.50.

(d) *Notice Format.* A notice of a proposed settlement should be entitled, "Notice of Proposed Settlement -- Request for Approval," and should provide the full name and address of the submitting insurer and the name, title, address, and telephone number of the designated contact person. An insurer must provide all relevant information, including the following, as applicable:

(1) A brief description of the insured's underlying claim, the insured's loss, the amount of the claim, the operative policy terms, defenses to coverage, and all damages sustained;

(2) An itemized statement of all damages by category (*i.e.,* actual, economic and non-economic loss, punitive damages, *etc.*);

(3) A statement from the insurer or its attorney recommending the settlement and the basis for the recommendation;

(4) The total dollar amount of the proposed settlement;

(5) Indication as to whether the settlement was negotiated by counsel;

(6) The net amount to be paid to the insured and/or third party;

(7) The amount to be paid that will compensate attorneys for their services and expenses and an explanation as to why the amount is not unreasonable;

(8) The amount received from the United States pursuant to any other Federal program for compensation of insured losses related to an act of terrorism;

(9) The proposed terms of the written settlement agreement, including release language and subrogation terms;

(10) Other relevant agreements, including:

(i) Admissions of liability or insurance coverage;

(ii) Determinations of the number of occurrences under a commercial property and casualty insurance policy;

(iii) The allocation of paid amounts or amounts to be paid to certain policies, or to specific policy, coverage and/or aggregate limits; and

(iv) Any other agreement that may affect the payment or amount of the Federal share of compensation to be paid to the insurer;

(11) A statement indicating whether the proposed settlement has been approved by the Federal court or is subject to such approval and whether such approval is expected or likely; and

(12) Such other information as may be requested by Treasury or its designee.

§ 50.84 Subrogation.

An insurer shall not waive its rights of subrogation under its insurance policy and shall take all steps necessary to preserve the subrogation right of the United States as provided by section 107(c) of the Act.

Dated: April , 2004

____
Wayne A. Abernathy
Assistant Secretary of the Treasury

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 3, 2004
JS-1497

The Honorable John W. Snow
Prepared Remarks to: The Council of the Ameri

Thank you so much for having me here today.

In a world that has grown smaller thanks to information and travel technology, it is more important and more attainable than ever before that a plurality of nations is prosperous. It is also easier than ever for nations to work together to achieve that goal.

The continuation of that growth is important to each individual country, and it is important to the world collectively.

I was reminded of that fact during my conversation with the G7 Ministers and Governors here in Washington two weekends ago.

The unifying theme of our discussions was economic growth, and the strengthening global recovery provided an upbeat backdrop.

I was proud to share the news of terrific economic growth here in the United States. President Bush's tax cuts have precipitated the growth that our country needed, and indicators are very good across the board, from GDP to consumer and business confidence to job creation.

And there is good news beyond the United States. Japan has turned in several good quarters, as has the United Kingdom. In continental Europe, there are some encouraging initial signs of an upturn, but growth still lags in too many areas and thus needs to be more broad-based.

My fellow G7 ministers and I agreed that this is the time to redouble our efforts to strengthen and broaden growth for the future. We reviewed the progress made under the G7 Agenda for Growth, including key steps on tax reform, and labor markets flexibility.

But we also agreed that additional pro-growth reforms are essential to boost employment and raise incomes. We focused in particular on the importance of low marginal tax rates in encouraging job creation and income growth.

Of course, sound fiscal policies are also fundamental to sustained growth, and we underscored the need for fiscal consolidation during times of expansion.

During the G7 meetings we were reminded of how important it is for leaders and governments to work together toward the shared goal of global growth. The purpose of your group is to encourage and foster that type of cooperation among countries in this region, and I applaud your work.

Latin America is a region that is very important to the United States. Our desire to see the Americas flourish is strong, and we appreciate the good working relationship that we have established with so many of the governments and leaders of the region.

There have been a considerable amount of improvements to economies in the region that I'd like to talk about today – because I think there are some key factors behind the successes.

I'd also like to discuss the efforts of the United States to reinforce the region's economic recovery and help the countries of Latin America lay a solid foundation for sustained growth.

Although the United States is a "young" country by world standards, we are the clear global leader in terms of prosperity and growth. Other countries are in awe of our resilience and our strength, and wish to emulate our formula for success.

I believe our economic strength has lasted, and recovered after hard times, because we have a solid foundation. Our country was built on the principles of the rights of the individual and the strength of the individual. In our founding, we established a free-market economy that we have maintained, and today strive to keep as unfettered as possible--deferring to individuals and businesses as engines of growth, not government. Government can only create the environment for growth.

Economic stability is a prerequisite for a thriving free-market society. The countries of Latin America have made important progress in improving economic stability over the last year and a half. Financial conditions have strengthened and capital flows to the region are up. I would like to take a few minutes to talk about the stronger fundamentals and better economic policies that are behind these improvements.

First, economic growth in the region is picking up along with the recovery in the global economy. GDP in the Americas was flat during 2002, then increased to 1.7 percent growth in 2003 and is expected to grow 3.5 to 4.0 percent in 2004. That's terrific news.

Second, external balances are strengthening in the countries of Latin America. The current account as a share of the region's GDP swung into surplus for the first time in decades in 2003. Central banks have wisely used the opportunity to increase their accumulation of foreign reserves to provide a cushion against future market turbulence.

Third, Latin American authorities have pursued sound fiscal and monetary policies. For example, six of the seven largest economies in Latin America – Brazil, Argentina, Colombia, Mexico, Chile and Peru – successfully increased primary budget surpluses to bring down debt levels over time and reduced or maintained low inflation in 2003.

Achievements in monetary policy in Brazil and Argentina merit special recognition. Both countries experienced large currency depreciations in 2002, but good monetary management prevented these depreciations from turning into inflationary spirals.

The positive consequences of strong fiscal and monetary policies are ongoing. In Brazil, for example, improved confidence in fiscal policy and the downward trend in inflationary expectations have enabled the central bank to aggressively cut interest rates over the last 10 months. Real interest rates are now less than 10 percent, which helps spur faster economic growth and levels of investment.

A fourth step that has led to improved, more stable economies is countries' progress on strengthening their debt profiles and deepening their domestic capital markets. For example, Brazil has sharply reduced the proportion of its debt that is linked to the exchange rate. Last year Mexico issued its first 20-year fixed-rate peso-denominated debt.

I should note that Latin American countries have also played a leading role and had great success in making bonds with collective action clauses the market standard, with Brazil, Colombia, Peru, Panama, Costa Rica, Uruguay and Venezuela following Mexico's pioneering issuance in February of 2003.

A final trend that has improved economic health in the region is countries' steps toward making structural reforms that will lock in improvements in macroeconomic policy.

For example, Argentina and Peru have worked to fight tax evasion and improve tax compliance. Success in those efforts is needed to avoid the pattern of ever-increasing tax rates chasing ever-lower collections.

Brazil and Colombia have moved forward with reforms of their public pensions, which free up savings that can be used to reduce public debt or increase key infrastructure investments.

More needs to be done in the region to lock in sound public finances, but the direction today is good. And the incentive to continue in this direction is strong. After all, countries that achieve and maintain good policies are positioned to benefit from, and contribute to, global economic growth.

With this progress in improving economic stability, it is now time to energize our efforts to remove the other barriers to higher long-run economic growth. What barriers stand in the way?

Simply put, anything that is constraining entrepreneurs and the formation of capital must be loosened or removed for the enormous potential of the region to be unleashed.

The economic success of the United States is due to the government policies that have done well by the entrepreneur. A good example of this: it takes an average of 70 days to start a business in Latin America. In the U.S., it takes about four days. Reducing the time it takes to start a business provides an enormous incentive for starting new enterprises and creating new jobs.

Businesses also need access to credit. So banks have to be sound and well-regulated, and do a better job of providing access to capital for productive entrepreneurs.

Labor markets have to operate efficiently and flexibly, allowing each individual to find jobs that maximize his or her potential. Society as a whole loses when poorly designed labor policies keep unemployment high and relegate workers to employment in the informal sector.

The tax, legal and regulatory environments also has to be such that risking capital is more attractive, more promising. This is especially true in the case of large, multi-year infrastructure projects where the returns are generated over an extended period of time.

Governments have to invest in health and education for their citizens – basic needs that build a foundation for human success.

And markets for goods and services have to be open for competition and for international trade.

These are the kinds of policies are essential for success in any country, anywhere in the world. Progress is being made on these fronts in the Americas, but a great deal remains to be done.

Our desire to see other countries prosper is why the Bush Administration has acted consistently and quickly to support countries that are pursuing pro-growth policies.

Accountability and ownership are essential to the success of these policies.

This has guided our approach to IMF engagement in the Americas. U.S. support for IMF programs in Colombia and Brazil in 2002 is a good example. In both instances, the governments articulated strong policy programs aimed at restoring stability through fiscal discipline and other reforms. International support succeeded in these instances because of the countries' strong ownership of good economic policies.

This emphasis on accountability and ownership has also guided our approach to U.S. development assistance, as evidenced in President Bush's Millennium Challenge Account (MCA), targeted toward countries that invest in people, pursue good governance and the rule of law, and promote economic freedom.

The MCA is an example of an initiative aimed at increasing economic growth, promoting job creation, and raising the standards of living in poor countries. That's also why we have such an ambitious trade agenda for the region. The U.S.-Chile Free Trade Agreement has already been completed, and an agreement with five Central American countries and the Dominican Republic has already been negotiated (CAFTA).

We have also announced our intent to negotiate an agreement with the Andean countries—aimed at eventually including Colombia, Peru, Ecuador and Bolivia—and to launch negotiations with Panama. A successful trade capacity-building exercise will continue under CAFTA and be replicated in negotiations for the Andean FTA. Our efforts also continue toward a Free Trade Area of the Americas that would encompass all countries in the Hemisphere in an integrated market.

We are committed to working with those in the region to create the environment for encouraging entrepreneurs. The U.S. is also proud to have led the effort at the Summit of the Americas to establish goals regarding the cutting of time and expense for starting a new business, and tripling bank lending to small and medium enterprises – with the help of the Inter-American Development Bank – by 2007. I do not need to tell this audience that small business is the engine of growth and job creation in Latin America and throughout the world.

A final issue that I want to mention today is U.S. support for facilitating access to remittances from workers in the United States to their families back home. This is a powerful and largely untapped source of funds for economic development, and we are committed to working with the countries of the region to achieve the Summit of the America's goal of halving the average cost of remittance transfers in the region by 2008.

When looking at the positive trends in the Americas, I am optimistic. Sustaining them and implementing additional pro-growth policies will take a lot of work, but I believe the time is ripe for economic success in the region.

I look forward to working with you on achieving that goal.

Thank you very much.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 3, 2004
JS-1498

Treasury Issues Guidance on Business Meal & Entertainment Expenses

The Treasury Department and the Internal Revenue Service today issued a revenue procedure providing guidance on the use of statistical sampling in determining deductible business meal and entertainment (M&E) expenses.

"Use of statistical sampling in this context significantly reduces taxpayer burden," said Acting Assistant Secretary for Tax Policy Gregory F. Jenner. "Providing guidance on how to use statistical sampling provides certainty and will reduce future controversy."

Deductions for M&E expenses generally are limited to 50 percent of the expense. However, the 50 percent disallowance does not apply to certain M&E expenses. This revenue procedure provides a statistical sampling methodology for use in establishing the amount of substantiated M&E expenses excepted from the 50 percent disallowance. The proper use of statistical sampling will relieve taxpayers, especially those with large M&E accounts, of the burden of scrutinizing each and every item relating to an M&E amount.

REPORTS

- Rev. Proc. 2004-29

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 I, §§ 132, 162, 274; 1.132-6.)

Rev. Proc. 2004-29

SECTION 1. PURPOSE

This revenue procedure provides the statistical sampling methodology that a taxpayer may use in establishing the amount of substantiated meal and entertainment expenses excepted from the 50% deduction disallowance of § 274(n)(1) of the Internal Revenue Code by reason of § 274(n)(2)(A), (B), (C), (D), or (E).

SECTION 2. BACKGROUND

.01 Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including certain expenses for meals and entertainment.

.02 Section 274(d) disallows a § 162 deduction for any expense for travel (including meals and lodging while away from home), entertainment, gifts, or listed property unless the taxpayer substantiates the elements of the expense by adequate records or by sufficient evidence. See § 1.274-5T of the Income Tax Regulations.

.03 Section 274(n)(1) provides that the amount allowable as a deduction for any expense for food or beverages, or any item with respect to an activity that is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with these activities, may not exceed 50% of the amount of the expense.

.04 Section 274(n)(2)(A) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to expenses described in § 274(e)(2) (expenses treated on the taxpayer's return as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24), (e)(3) (expenses paid or incurred under a reimbursement or similar arrangement in connection with the performance of services), (e)(4) (recreational and similar expenses for employees), (e)(7) (expenses relating to items available to the public), (e)(8) (expenses relating to entertainment sold to customers), or (e)(9) (expenses includible in income of persons who are not employees).

.05 Section 274(n)(2)(B) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to an expense for food or beverages that is excludable from the gross income of the recipient under § 132(e) (relating to de minimis fringe benefits excluded from income under § 132(a)(4)).

.06 Section 132(e) defines a de minimis fringe as any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. Under § 1.132-6(c), a cash fringe benefit (other than overtime meal money and local transportation fare) is never excludable as a de minimis fringe benefit. For example, expenses for meals and entertainment reimbursed to employees under an accountable plan (as defined in § 1.62-2(c)(2)) do not qualify as de minimis fringe benefits.

.07 Section 1.132-6(b) provides that the frequency with which similar fringes are provided by the employer to the employer's employees is generally determined by reference to the frequency with which the employer provides the fringes to each individual employee. However, if it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the workforce as a whole. This exception to the employee-measured frequency requirement does not apply to overtime meals, meal money, or local transportation fare.

.08 Section 274(n)(2)(C) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to an expense covered by a package involving a ticket described in § 274(l)(1)(B) (exception for certain charitable sports events).

.09 Section 274(n)(2)(D) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to taxable payments or reimbursements of moving expenses of an employee by the employer.

.10 Section 274(n)(2)(E) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to expenses for food or beverages (i) required by Federal law to be provided to crew members of a commercial vessel, (ii) provided to crew members of certain commercial vessels, or (iii) provided on or in proximity to certain oil or gas platforms or drilling rigs.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer filing an original return, under examination, in litigation, or making a refund claim that desires to establish with respect to its income tax liability the amount of substantiated expenses paid or incurred for meals and entertainment excepted from the 50% deduction disallowance of § 274(n)(1) by reason of § 274(n)(2)(A), (B), (C), (D), or (E).

SECTION 4. APPLICATION

.01 In general. A taxpayer filing an original return, under examination, in litigation, or making a refund claim, may use statistical sampling in connection with establishing, with respect to its income tax liability, the amount of the taxpayer's substantiated expenses paid or incurred for meals and entertainment excepted from the 50% deduction disallowance of § 274(n)(1) by reason of § 274(n)(2)(A), (B), (C), (D), or (E) by following the procedures provided in Appendix A (Sampling Plan Standards), Appendix B (Sampling Documentation Standards), Appendix C (Technical Formulas), and (in the case of de minimis fringes) in paragraph 4.02 of this revenue procedure.

.02 Additional procedures required for de minimis fringe benefits.

(1) Reimbursements under accountable plans. In conducting the study, expenses for meals and entertainment reimbursed by employers to employees under an accountable plan may not be treated as de minimis fringe benefits.

(2) Determination of frequency. To establish the amount of identified expenses that are excepted from § 274(n)(1) by reason of § 274(n)(2)(B), a taxpayer is required to determine the frequency with which similar fringes were provided by the taxpayer to the taxpayer's employees on an employee-measured or employer-measured basis, as described in paragraphs (3) and (4) below. Thus, after selecting a statistical sample, as discussed below, the taxpayer may be required to review documentation from outside both the sample and the target population (the set of items from which the sample is drawn) to identify similar fringes included in employees' gross

income and similar fringes previously excluded from employees' gross income as de minimis fringe benefits.

(3) Employee-measured frequency.

(a) In general. When using employee-measured frequency to determine the amount of identified expenses that are excepted from § 274(n)(1) by reason of § 274(n)(2)(B), the taxpayer must establish the frequency with which similar fringes were provided to each individual employee of the taxpayer. Therefore, after identifying the statistical sample, the taxpayer must review the remainder of the target population (and records that document similar fringes that are not included in the target population) to identify the aggregate number of similar fringes provided to the individual employees included in the statistical sample.

(b) Example. Taxpayer maintains a meal and entertainment expense account that includes invoices for meals provided in-kind to Taxpayer's employees that may be de minimis fringe benefits. The invoices specifically identify the employees who received the in-kind meals. Therefore, it would not be administratively difficult to determine the frequency with which in-kind meals were provided to individual employees, and Taxpayer must determine the frequency with which it provided in-kind meals to each of the individual employees included in the sample. Taxpayer has no other accounts that include expenses for in-kind meals provided to employees.

Taxpayer selects a statistical sample of the meal and entertainment expense account that identifies 10 employees who have received in-kind meals. In order to determine if the meals are de minimis fringes, Taxpayer must review documentation (such as invoices) in the remainder of the target population to identify all in-kind meals provided to each of the 10 individual employees included in the sample. Taxpayer must consider in-kind meals that Taxpayer included in each employee's gross income and similar fringes previously excluded from the employees' gross income as de minimis fringe benefits in determining the frequency with which similar fringes were provided to each of the 10 employees. After conducting this review, Taxpayer determines (after considering both the value and frequency of the meals) that the meals provided to 4 of the 10 employees in the sample are de minimis fringe benefits not subject to the 50% deduction disallowance of § 274(n)(1). Taxpayer may increase proportionately the deductible amount of expenses in the population not subject to the § 274(n)(1) limitation. See paragraph 6 of Appendix A.

(4) Employer-measured frequency.

(a) In general. When using employer-measured frequency to determine the amount of identified expenses that are excepted from § 274(n)(1) by reason of § 274(n)(2)(B), the taxpayer must establish the frequency with which similar fringes were provided to the taxpayer's workforce as a whole. Thus, the target population must include all relevant records prior to selection of the statistical sample in order to determine the aggregate number of similar fringes provided to all eligible employees and the aggregate number of employees eligible to receive such fringes.

(b) Example. Taxpayer maintains a meal and entertainment expense account that includes invoices for meals provided in-kind to Taxpayer's employees that may be de minimis fringe benefits. The invoices are for in-kind meals of a type for which it is administratively difficult to identify the particular employees who received the meals, and the invoices do not specifically identify those employees. Therefore, it would be administratively difficult to determine the frequency with which in-kind meals were provided to individual employees, and Taxpayer may determine the frequency with which similar fringes were provided by Taxpayer to Taxpayer's employees by reference to all employees eligible to receive in-kind meals. Taxpayer maintains an account in addition to the meal and entertainment expense account that includes expenses for in-kind meals provided to employees. Taxpayer's workforce includes 500 employees who are eligible to receive the fringe benefit of in-kind meals.

Taxpayer merges the meal and entertainment expense account and the other account that includes expenses for in-kind meals to create a target population that includes all relevant records and conducts a statistical sample of the merged accounts. In determining whether the in-kind meals included in the sample are de minimis fringes, Taxpayer must consider in-kind meals that Taxpayer included in eligible employees' gross income and similar fringes previously excluded from employees' gross income as de minimis fringe benefits. Taxpayer identifies in the sample 50 in-kind meals provided to employees. The 50 meals represent 1000 in-kind meals in the target population as a whole, or two meals per eligible employee. Assuming that the provision of two meals with a given cost per eligible employee results in a value that is so small as to make accounting for it unreasonable or administratively impracticable, Taxpayer may treat all of the in-kind meals in the meal and entertainment expense account as de minimis fringe benefits not subject to the 50% deduction disallowance of § 274(n)(1), subject, however, to a pro rata reduction to the extent that any in-kind meals are evaluated under employee-measured frequency and fail to qualify as de minimis fringes.

.03 Limitations.

(1) This revenue procedure does not authorize the use of statistical sampling to substantiate meal and entertainment expenses as required by § 274(d).

(2) This revenue procedure does not authorize the use of statistical sampling to determine a taxpayer's liability for employment taxes or whether an amount is excludable from a taxpayer's income.

(3) This revenue procedure does not establish the correctness of a taxpayer's interpretation of § 274(n) or characterization of meal and entertainment expenses as expenses excepted from § 274(n)(1).

(4) This revenue procedure does not preclude the Internal Revenue Service from raising or pursuing any income, employment, or other tax issues identified in the review of a statistical sample.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after May 3, 2004. However, with respect to the use of statistical sampling by a taxpayer for a taxable year ending before May 3, 2004, for which the applicable period of limitations has not expired, the Service will permit, but not require, application of this revenue procedure.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1847.

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

The collection of information in this revenue procedure is in Appendix B. This information is required to ensure compliance with the statistical sampling methodology contained in this revenue procedure. The information will be used to evaluate compliance with the procedures described in this revenue procedure. The collection of information is mandatory. The likely recordkeepers are businesses or other for-profit institutions.

The estimated total annual recordkeeping burden is 3200 hours. The estimated annual burden per recordkeeper varies from six to ten hours, depending on individual circumstances, with an estimated average of eight hours. The estimated number of recordkeepers is 400.

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.

DRAFTING INFORMATION

The principal author of this revenue procedure is Kari L. Fisher of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Fisher at (202) 622-4970 (not a toll-free call). For further information regarding Appendices A, B and C, contact Ed Cohen of the Large and Mid-Size Business Division at (212) 719-6693 (not a toll-free call).

APPENDIX A

SAMPLING PLAN STANDARDS

The statistical sampling must be conducted in accordance with the following methodology.

1. Statistical (probability) sampling methodology may not include the use of judgment sampling.

2. Taxpayers may apply the results of a statistical sample only to the taxable years included in the sample.

3. A statistical sample may include data from no more than three consecutive taxable years.

4. Data from a taxable year may be included in only one statistical sample.

5. The estimated amount of expenses not subject to the § 274(n)(1) limitation must be based on a statistical (probability) sample, in which each sampling unit has a known (non-zero) chance of selection, using either a simple random sampling method or stratified random sampling method.

6. In general, the computation of the estimated amount of expenses not subject to the § 274(n)(1) limitation must be at the least advantageous 95% one-sided confidence limit. The "least advantageous" confidence limit is either the upper or lower limit that results in the least benefit to the taxpayer. However, if the precision of the change in the estimated deductible amount of expenses not subject to the § 274(n)(1) limitation (see paragraph 9 below) divided by the change in the estimated deductible amount of expenses not subject to the § 274(n)(1) limitation does not exceed 10%, the point estimate may be used in place of the least advantageous confidence limit. All strata for which "substantially all" of the population sampling units are sampled will be treated as 100% strata. That is, the overall point estimate and its precision will be estimated by treating all 100% strata appropriately for the sample design used. Also, the calculation of the denominator for the relative precision will exclude all 100% strata. For this revenue procedure, "substantially all" is defined as 80% or more.

7. Recognizing that many methods exist to estimate population values from the sample data, the Service will consider acceptable only the following estimators. Variable

estimators permitted include the mean (also known as the direct projection method), difference (using "paired variables"), (combined) ratio (using a variable of interest and a "correlated" variable), and (combined) regression (using a variable of interest and a "correlated" variable). The first variable used for the difference, ratio and regression estimators must be the variable used in the mean estimator. The second variable used for the difference, ratio and regression estimators must be a variable that can be paired with the first variable and should be related to the first variable. For example, in a typical audit-sampling situation, the first variable would be the audited value of a transaction and the second variable would be the originally reported value of the same transaction. Since the latter two variable methods are statistically biased, there must be a demonstration that the bias is negligible before the Service will accept the method.

8. Variable sampling plans must use the qualifying final estimate with the smallest overall standard error as an absolute value (for example, the size of the estimate is irrelevant in the determination of the reported value).

9. Variable sampling plans must calculate confidence limits by addition and subtraction of the precision of the estimate from the point estimate in which the determination of precision proceeds by multiplication of the standard error by (i) the 95% one-sided confidence coefficient based on the Student's *t*-distribution with the appropriate degrees of freedom, or (ii) 1.645 (the normal distribution), assuming the sample size is at least 100 in each non-100% stratum.

10. For either the (combined) ratio or regression methods, to demonstrate little statistical bias exists, the following applies after excluding all strata tested on 100% basis (the entire population of a stratum is selected for evaluation).

a. The total sample size of all strata must be at least 100 units.

b. Each stratum for a population estimate should contain at least 30 sample units.

c. The coefficient of variation of the paired variable must be 15% or less. The coefficient of variation of the paired variable (y) is defined as the standard error of the total "y" variables divided by point estimate of the total "y" variables when the "y" variables are commonly the reported values in accounting situations.

d. The coefficient of variation of the primary variable of interest, represented by either the corrected value or the difference between the reported and corrected values in common accounting situations, must be 15% or less. The coefficient of variation for the corrected value (x) is defined as the standard error of the total "x" variables divided by point estimate of the total "x" variables when the "x" variables are commonly the corrected values in accounting situations. The coefficient of variation for the difference (d) between the reported and corrected values (x-y) is defined as the smaller of the standard error of the total "x-y" or total "d" variables divided by the amount equaling total population value represented by "Y" plus point estimate of the total "x-y" or total "d" variables or the standard error of the total "x-y" or total "d" variables divided by the total "x-y" or total "d" variables when the "x-y" variables are commonly the difference ("d") between the reported ("y") and corrected ("x") values in accounting situations.

e. For only the (combined) ratio method, the reported values of units must be of the same sign.

11. When sampling the same expense accounts for multiple taxable years, if a single projection does not materially affect other computations that are more appropriately made on a yearly basis, it is permissible to combine the accounts into one population.

There should be allocation of the combined result by a reasonable method determined prior to the selection of the sampling units.

12. A written sampling plan is required prior to the execution of a sample. A plan must include the following:

a. The objective of the plan including a description of the value for estimation and the applicable taxable year(s);

b. Population definition and reconciliation of the population to the tax return;

c. Definition of the sampling frame;

d. Definition of the sampling unit;

e. Source of the random numbers, the starting point or seed, and the method of selection;

f. Sample size, along with supporting factors in the determination;

g. Method to associate random numbers to the frame;

h. Steps to ensure that the serialization of the frame is independent of the drawing of random numbers;

i. Steps for evaluating the sampling unit; and

j. The estimator that was used for appraising the sample.

APPENDIX B

SAMPLING DOCUMENTATION STANDARDS

The taxpayer must retain adequate documentation to support the statistical application, sample unit findings, and all aspects of the sample plan and execution. The execution of the sample must include information for each of the following items:

1. The seed or starting point of the random numbers;

2. The pairing of random numbers to the frame along with supporting information to retrace the process;

3. List of sampling units selected and the results of the evaluation of each unit;

4. Supporting documentation such as notes, invoices, purchase orders, project descriptions, etc., which support the conclusion reached about each sample item;

5. The calculation of the projected estimate(s) to the population, including computation of the standard error of the estimate(s);

6. A statement describing any slips or blemishes in the execution of the sampling procedure and any pertinent decision rules; and

7. Computation of all associated adjustments.

APPENDIX C

TECHNICAL FORMULAS

The formulas below are included to clarify the statistical sampling terms used and to ensure consistent application of the procedures described in the revenue procedure.

UNSTRATIFIED (SIMPLE RANDOM SAMPLE) MEAN ESTIMATOR	STRATIFIED MEAN ESTIMATOR

Sample Mean of Audited Amounts

$$\bar{x} = \frac{\sum x_j}{n}$$

Estimate of Total Audited Amount

$$\hat{X}_M = N\bar{x}$$

$$\hat{X}_{Ms} = \sum(N_i\,\bar{x}_i)$$

Estimated Standard Deviation of the Audited Amount

$$S_X = \sqrt{\frac{[\Sigma(x_j^2)] - n(\overline{x}^2)}{n-1}}$$

Estimated Standard Error of the Total Audited Amount

$$\hat{\sigma}(\hat{X}_M) = \frac{NS_x\sqrt{1 - {}^{n}\!/\!_{N}}}{\sqrt{n}}$$

$$\hat{\sigma}(\hat{X}_{Ms}) = \sqrt{\Sigma\left[N_i\,(N_i - n_i)\frac{S_{xi}^{2}}{n_i}\right]}$$

Achieved Precision of the Total Audited Amount

$$A'_M = \frac{NU_R S_x\sqrt{1 - {}^{n}\!/\!_{N}}}{\sqrt{n}}$$

$$A'_{Ms} = U_R\sqrt{\Sigma\left[N_i\,(N_i - n_i)\frac{S_{xi}^{2}}{n_i}\right]}$$

**UNSTRATIFIED (SIMPLE RANDOM SAMPLE)
DIFFERENCE ESTIMATOR**

**STRATIFIED
DIFFERENCE ESTIMATOR**

Estimate of Total Difference

$$\hat{D} = N\overline{d}$$

$$\hat{D}_S = \Sigma(N_i\,\overline{d_i})$$

Estimate of Total Audited Amount

$$\hat{X}_D = Y + \hat{D}$$

$$\hat{X}_{Ds} = Y + \hat{D}_s$$

Estimated Standard Deviation of the Difference Amount

$$S_D = \sqrt{\frac{\left[\Sigma(d_j^2)\right] - n(\overline{d}^2)}{n-1}}$$

Estimated Standard Error of the Difference Amount

$$\hat{\sigma}(\hat{D}) = \frac{NS_D\sqrt{1 - {}^{n}\!/\!_{N}}}{\sqrt{n}}$$

$$\hat{\sigma}(\hat{D}_S) = \sqrt{\Sigma\left[N_i\,(N_i - n_i)\frac{S_{D_i}^{2}}{n_i}\right]}$$

Achieved Precision of the Difference Amount

$$A'_D = \frac{NU_R S_D \sqrt{1 - {}^{n}\!/\!_{N}}}{\sqrt{n}}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE)
RATIO ESTIMATOR

$$A'_{Ds} = U_R \sqrt{\Sigma \left[N_i (N_i - n_i) \frac{S_{D_i}^2}{n_i} \right]}$$

STRATIFIED
COMBINED RATIO ESTIMATOR

Estimated Ratio of Audited Amount to Recorded Amount

$$R = \frac{\Sigma\, x_j}{\Sigma\, y_j} = 1 + \frac{\Sigma\, d_j}{\Sigma\, y_j}$$

$$\hat{R}_C = \frac{\Sigma(N_i\, \bar{x}_i)}{\Sigma(N_i\, \bar{y}_i)} = 1 + \frac{\Sigma(N_i\, \bar{d}_i)}{\Sigma(N_i\, \bar{y}_i)}$$

Estimate of Total Audited Amount

$$\hat{X}_R = Y\hat{R}$$

$$\hat{X}_{Rc} = Y\hat{R}_C$$

Estimated Standard Deviation of the Ratio

$$S_R = \sqrt{\frac{\Sigma(x_j^2) + \hat{R}^2\, \Sigma(y_j^2) - 2\hat{R}\, \Sigma(x_j y_j)}{n-1}}$$

Estimated Standard Deviation of the Ratio in *i*th Stratum

$$S_{RC_i} = \sqrt{\frac{[(\Sigma x_{ij}^2 - (\Sigma x_{ij})^2 / n_i)] + [\hat{R}_C^2 (\Sigma y_{ij}^2 - (\Sigma y_{ij})^2 / n_i)] - [2\hat{R}_C (\Sigma x_{ij} y_{ij} - n_i\, \bar{x}_i\, \bar{y}_i)]}{n_i - 1}}$$

Estimated Standard Error of the Ratio Amounts

$$\hat{\sigma}(\hat{X}_R) = \frac{NS_R \sqrt{1 - {}^{n}\!/\!_{N}}}{\sqrt{n}}$$

$$\hat{\sigma}(\hat{X}_{Rc}) = \sqrt{\Sigma \left[N_i (N_i - n_i) \frac{S_{Rc_i}^2}{n_i} \right]}$$

Achieved Precision of the Ratio Amounts

$$A'_R = \frac{NU_R S_R \sqrt{1 - {}^{n}\!/\!_{N}}}{\sqrt{n}}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE)
REGRESSION ESTIMATOR

$$A'_{Rc} = U_R \sqrt{\Sigma \left[N_i (N_i - n_i) \frac{S_{Rc_i}^2}{n_i} \right]}$$

STRATIFIED
COMBINED REGRESSION ESTIMATOR

Estimated Regression Coefficient

$$b = \frac{[\Sigma(x_j y_j)] - n\overline{x}\,\overline{y}}{[\Sigma(y_j^2)] - n(\overline{y}^2)} = 1 + \frac{[\Sigma(d_j y_j)] - n\overline{d}\,\overline{y}}{[\Sigma(y_j^2)] - n(\overline{y}^2)} \qquad b_c = \frac{\Sigma N_i(N_i - n_i)S_{XYi}/n_i}{\Sigma N_i(N_i - n_i)S_{Yi}^2/n_i} = 1 + \frac{\Sigma N_i(N_i - n_i)S_{DYi}/n}{\Sigma N_i(N_i - n_i)S_{Yi}^2/n}$$

Estimate of Total Audited Amount

$$\hat{X}_G = N\overline{x} + b(Y - N\overline{y}) \qquad \hat{X}_{GC} = \Sigma(N_i\,\overline{x_i}) + b_C[Y - \Sigma(N_i\,\overline{y_i})]$$

Estimated Standard Deviation of the Regression Amounts

$$S_G = \sqrt{\frac{1}{n-2}\left[[\Sigma(x_j^2)] - n(\overline{x}^2) - \frac{(\Sigma(x_j y_j) - n\overline{x}\,\overline{y})^2}{\Sigma(y_j^2) - n(\overline{y}^2)}\right]}$$

Estimated Covariance between the Audited and Recorded Amounts in i^{th} Stratum

$$S_{XY_i} = \frac{[\Sigma(x_{ij}y_{ij})] - n_i\,\overline{x_i}\,\overline{y_i}}{n_i - 1}$$

Estimated Standard Deviation between the Audited and Recorded Amounts in i^{th} Stratum

$$S_{GC_i} = \sqrt{S_{Xi}^2 - 2b_C S_{XY_i} + b_C^2\,S_{Yi}^2}$$

Estimated Standard Error of the Audited and Recorded Amounts

$$\hat{\sigma}(\hat{X}_G) = \frac{NS_G\sqrt{1 - n/N}}{\sqrt{n}} \qquad \hat{\sigma}(\hat{X}_{Gc}) = \sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Gc_i}^2}{n_i}\right]}$$

Achieved Precision of the Audited and Recorded Amounts

$$A'_G = \frac{NU_R S_G\sqrt{1 - n/N}}{\sqrt{n}} \qquad A'_{Gc} = U_R\sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Gc_i}^2}{n_i}\right]}$$

Definition of Symbols

TERM	DEFINITION

n	Sample Size
N	Population Size
x	The value of the sampling unit that is being used as the primary variable of interest. In audit sampling, this would be the audited (or revised) value of the transaction.
y	The value of the sampling unit that is being used as the "paired" variable that is related to the variable of interest. In audit sampling, this would be the reported (or original) value of the transaction.
d	The value of the sampling unit that is the difference between "paired" variable (y) and the variable of interest (x). That is, $d = x - y$. In audit sampling, this would be the difference (or the change) of each transaction's value.
X	The total value of the primary variable of interest. In audit sampling, this would be the estimated total audited value of the population. Typically, this value is not known for the entire population and is estimated based on the probability sample selected.
Y	The total value of the variable that is paired with variable of interest. In audit sampling, this would be the total reported value of the population. Typically, this value is known for the entire population and may be estimated based on the probability sample selected.
D	The total value of the difference between the "paired" variable and the variable of interest. In audit sampling, this would be the estimated total difference of the population. Typically, this value is not known for the entire population and is estimated based on the probability sample selected.
U_R	The confidence coefficient which is based on either the Student's *t*-distribution or the normal distribution. For example, a 95% one-sided confidence coefficient based on the normal distribution is 1.645. This term is often referred to as the *t*-value and the *z*-value.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 3, 2004
JS-1489

Treasury Announces Market Financing Estimates

The Treasury Department announced today that it expects net borrowing of marketable debt to total $38 billion in the April – June 2004 quarter. The projected cash balance on June 30 is $45 billion. In the last quarterly announcement on February 2, 2004, Treasury announced that it expected net borrowing to total $75 billion with an end-of-quarter cash balance of $45 billion. The decrease in borrowing is due to higher receipts, both from lower refunds and higher payroll and individual taxes, lower outlays, and higher State and Local Government Series net issuances.

Treasury also announced that it expects net borrowing of marketable debt to total $91 billion in the July – September 2004 quarter. The projected cash balance on September 30 is $35 billion.

During the January – March 2004 quarter, Treasury's net marketable borrowing totaled $146 billion and the cash balance on March 31 was $21 billion. On February 2, Treasury announced that it expected net marketable borrowing to total $177 billion with an end-of-quarter cash balance of $20 billion. The decrease in borrowing is largely attributable to lower tax refunds and higher payroll taxes.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, May 5.

REPORTS

- Treasury Announces Market Financing Estimates

TREASURY ANNOUNCES MARKET FINANCING ESTIMATES

Today, the Treasury Department announced net borrowing of marketable debt for the April – June 2004 and July – September 2004 quarters.

Quarter	Estimated Borrowing ($ billion)	End-of-Quarter Cash Balance ($ billion)
Apr-Jun 2004	$38	$45
Jul-Sep 2004	$91	$35

Since 1997, the average forecast error in net market borrowing for the current quarter is $10 billion, of which $1 billion is attributable to differences in the end-of-quarter cash balance. Similarly, the average forecast error for the following quarter is $45 billion, of which $10 billion is attributable to differences in the end-of-quarter cash balance.

The following tables display and reconcile the variation between forecasted and actual net marketable borrowing in the Jan - Mar 2004 quarter.

Quarter	Estimated Borrowing ($ billions)	Actual Borrowing ($ billions)	Estimated End-of-Quarter Cash Balance ($ billions)	Actual End-of-Quarter Cash Balance ($ billions)
Jan - Mar 2004	$177	$146	$20	$21

-more-

Categories	Chg from Feb Estimate
Receipts	+$30**
Outlays	+$4
Non-Marketable Activity	-$2
Change in Cash Balance	-$1

** includes tax refunds

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, May 5.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 3, 2004
JS-1499

Assistant Secretary of the Office of Economic Policy Mark J. Warshawsky Statement for the Treasury Borrowing Advisory Committee of the Bond Market Association

The three months since the previous meeting of the Advisory Committee saw the economy continue to grow at a lively pace. The strong gains in real GDP that we experienced in the last two quarters of 2003 extended into the first quarter, with GDP rising at a 4.2 percent annual rate. The 5.5 percent average pace in the latest three quarters was the largest since 1984. With the assistance of tax cuts, growth has become self-sustaining. It is also more balanced than earlier in the recovery, with numerous supports providing a strong platform for continued economic momentum going forward.

Business investment in equipment and software posted its third straight double-digit increase in the first quarter, rising at an 11.5 percent rate. Demand for capital goods continues to be supported by the expensing provisions of the stimulus legislation of the past two years, as well as the renewed strength in corporate profits in recent quarters. Corporate profits in economic terms (from current production, as measured in the GDP accounts) were almost 30 percent higher at the end of last year than a year earlier, and the profit margin (profits in relation to gross domestic income) hit a 6-year high, in large part because sizable gains in productivity are holding down unit costs. Increased inventory building also added to growth in each of the past two quarters, although by only a small amount in the first quarter. Inventory-sales ratios are extremely low by any measure, suggesting that future sales increases will have to be met through additional production rather than by drawing down already-low stocks. In addition, as business confidence in the durability of aggregate demand strengthens further, inventory investment should be a positive influence on real growth in coming quarters. The resumption of inventory accumulation and strong demand for investment and consumer goods has already led to increased production, with manufacturing output rising at approximately a 6 percent annual rate in each of the past two quarters.

Rising profits and investment, as well as renewed optimism, spurred businesses to hire additional workers. After modest gains in the prior six months, employment roared back in March with a 308,000 surge in the number of payroll jobs. Combined with sizable upward revisions to the figures for January and February, that brought total job growth to 759,000 over the past seven months. Other indicators of labor market activity are also showing signs of strength. For example, initial unemployment insurance claims are in a range that is consistent with job growth, corporate layoff announcements as measured by the job placement firm Challenger, Gray and Christmas diminished, and the purchasing managers' indexes for both manufacturing and non-manufacturing are signaling job growth.

Renewed job gains have already led to improved growth of aggregate wages and salaries. Combined with lower taxes, this helped boost growth of disposable personal income (DPI) to a 4.3 percent annual rate in the first quarter in real terms and by 4.1 percent over the past year, representing the largest 4-quarter increase in real DPI in almost two years. Strength in income has supported personal spending. Led by increased purchases of services and nondurable goods such as apparel, real personal consumption expenditures accelerated from a 3.2 percent pace in the fourth quarter to 3.8 percent in the first, despite reduced expenditures on motor vehicles. Stronger job and wage growth should provide a solid impetus to consumption in coming quarters.

The housing market also provided a lift to the economy in the first quarter. New home sales hit a record 1.2 million unit annual rate in March, as performance continues to surprise on the upside. Mortgage rates came down in the last two quarters which helped spur home sales, though rates crept up in April. Strong underlying fundamentals have supported the high level of housing demand, including favorable demographic trends, greater levels of affordability due to rising after-tax incomes, innovations in housing finance that expanded the market to more creditors without compromising credit quality, and the low interest rates. These factors have helped push the homeownership rate to a record 68.6 percent in the last two quarters.

Exports posted a third straight quarterly increase in the first quarter, though the pace slowed substantially. Exports grew at a 3.2 percent annual rate compared to an outsized gain of more than 20 percent in the previous quarter. Imports rose as well but the changes were offsetting, leaving the net export trade deficit virtually unchanged at $514.6 billion in real (2000 $) terms.

Inflation remains generally subdued with the exception of energy prices and prices of selected commodities at the earliest stages of processing, such as lumber and metals. The price index for core personal consumption expenditures (excluding food and energy), probably the best barometer of underlying inflation trends, rose 2.0 percent at an annual rate in the first quarter but was up just 1.3 percent over the past year. Special factors can cause inflation to move around from quarter to quarter but the underlying fundamentals suggest that it will remain benign for some time to come. Excess capacity in both product and labor markets, along with strong productivity growth, indicates that prices should remain well contained.

The U.S. economy is poised for a continuation of solid growth in real GDP through the rest of the year and into 2005. Productivity, corporate profits and investment are expected to maintain strong rates of growth, and consumption will also be supported by rising employment and income.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

April 30, 2004
JS-1500

Terrorist Kidnappers Designated by Treasury
Captors Boast Ties to al Qaida

The U.S. Department of the Treasury today announced the designation of four individuals with ties to the Salafist Group for Preaching and Combat (GSPC) for the kidnappings of 32 tourists between February and March of 2003. This designation was taken pursuant to Executive Order 13224.

The U.S. is taking action today in support of Germany's decision to designate the individuals and submit their names to the United Nations (U.N.) 1267 Sanctions Committee to be added to the Consolidated List of individuals and entities designated due to their affiliation with Usama bin Laden, al Qaida and the Taliban..

"Terrorists continue to use all means and methods to threaten the safety of the citizens of the world – regardless of their nationality, race or religion," said Juan Zarate, the Treasury Department's Deputy Assistant Secretary for the Executive Office for Terrorist Financing and Financial Crimes.

"Our action today to designate these kidnapping thugs, in support of the German notification to the United Nations, is part of the ongoing global commitment to combat terrorism. Our success in the financial war on terror will continue to depend on the diligence, aggressiveness and cooperation of our international partners," Zarate continued.

The kidnappings, which took place in south-east Algeria, included sixteen Germans, ten Austrians, four Swiss, one Dutch and one Swede who was born and currently resides in Germany. In May 2003, Algerian armed forces freed 17 tourists being held hostage by the GSPC. After negotiations led by representatives of the Government of Mali and with the participation of representatives of the German Federal Government, the remaining hostages were released in August of that year. While in captivity, one of the hostages died of heatstroke.

The individuals being designated today, Kamel Djermane, Ahmad Zerfaoui, Dhou El-Aich and Hacene Allane, are considered to be part of subgroups of the Tarek Ibn Ziad group. These subgroups, Thabet and Adel, were involved in the GSPC kidnappings.

Kamel Djermane – According to information, Dejermane is a member of the intermediate leadership of the Tarek Ibn Ziad group.

Ahmad Zerfaoui – Information concludes that Zerfaoui, as the leader of a Tarek Ibn Ziad subgroup, was responsible for the kidnapping of the first group of tourists that were taken hostage in February of 2003.

Dhou El-Aich – Particular information concluded that El-Aich was a leader of the Thabet subgroup of the Tarek Ibn Ziad group.

Hacene Allane – Accusations conclude that Allane belonged to the intermediate leadership of the Adel subgroup of the Tarek Ibn Ziad group and that he acted as a communicator between the kidnappers and the hostages.

Saifi AMMARI, the individual mainly responsible for the kidnappings, was designated by the Treasury Department on December 5, 2003 and was added to the U.N.'s Consolidated List. GSPC was previously designated by the U.S. as a specially designated global terrorist and has been on the list of the U.N.'s al Qaida/Taliban Sanctions Committee since October 6, 2001.

Executive Order 13224 provides means to disrupt the support network for terrorism. Under this order, the United States government may block the assets of individuals and entities providing support – financial or otherwise – to designated terrorists and terrorist organizations, who act for or on the behalf of designated terrorists or who are otherwise associated with designated terrorists. Blocking actions are critical to combating the financing of terrorism.

When a blocking action is put into place, any assets that exist in the formal financial system at the time of the orders are frozen and any future transactions through the formal financial system are restricted. Blocking actions serve additional functions as well, including serving as a deterrent for non-designated parties who might otherwise be willing to finance terrorist activity; exposing terrorist financing "money trails" that may generate leads to previously unknown terrorist cells and financiers; disrupting terrorist financing networks by encouraging designated terrorist supporters to disassociate themselves from terrorist activity and renounce their affiliation with terrorist groups; terminating terrorist cash flows by shutting down the pipelines used to move terrorist-related assets; forcing terrorists to use alternative, more costly and higher-risk means of financing their activities; and engendering international cooperation and compliance with obligations under U.N. Security Council Resolutions.

With today's action, the U.S. and our international partners have designated 365 individuals and organizations as terrorists and terrorist supporters and have frozen approximately $139 million and seized more than $60 million in terrorist-related assets.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

April 29, 2004
js-1501

Testimony of Samuel W. Bodman, Deputy Secretary U.S. Department of the Treasury Before the Senate Committee on Banking, Housing and Urban Affairs

I. Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today about the Treasury Department's central role in the international war against terrorist financing and financial crime. I welcome this opportunity to discuss this subject with you, and to outline our vision for moving forward in this vitally important fight.

Though I have only been at the Treasury Department for a short period, it is clear to me that this Department is well placed to shape policy and practice in areas of financial and economic interest that affect our national security. Through its broad authorities and expertise, the Treasury Department is charged with preserving the integrity of the financial system and does so every day by charting our counter-terrorist financing campaign; setting and implementing anti-money laundering and counter-terrorist financing polices, regulations, and standards at home and abroad; gathering and sharing financial information with law enforcement and foreign counterparts regarding financial crime; implementing our nation's economic sanctions; and enforcing relevant regulations and laws related to these missions. Of course, this is done in close coordination with our partners at the Departments of Justice, State, Homeland Security, and all other relevant Federal departments and agencies.Immediately after September 11th, the President directed the Treasury Department to guide the Federal Government's efforts in the global war against the financing of terrorism. Since that time, we have continued to devote our resources and extensive expertise to ensure that financial intermediaries and facilitators who infuse terrorist organizations with money, materiel, and support are held accountable along with those who perpetrate terrorist acts.

The war on terrorist financing is a vital responsibility of the Department. Terrorists – like any other organized criminals – rely on financial networks to fund and support their activities. Disrupting and dismantling those networks can make it more difficult for terrorists to carry out their deadly activities. Our success, therefore, can save the lives of Americans and of our friends and allies.

We know that the United States Government has had an effect on the ability of al Qaida and other terrorists to raise and move money around the world. The designations and other actions we have taken have made it riskier and costlier for them to try to use the formal financial system – which previously provided an open gateway for their funds to be sent instantly around the world. Our domestic and international efforts have tightened the net in the international financial system – through greater oversight, transparency, diligence, and capacity. Because of these efforts, terrorists have had to change the way they do business and are relying more on home-grown methods of raising money and slower methods of moving money. These are signals of our success.

As the recent bombings in Madrid and Riyadh demonstrate, however, we still have much work to do. Commitment to defeat terrorism is not enough. We must ensure that our commitment to disrupt and dismantle terrorist financing networks is matched by tangible results. I believe that we have achieved important and considerable results, but that we can and must do more, building not only upon our successes against terrorist financing, but also upon our experience and expertise in combating financial crime generally.

What is clear is that the rest of world has now begun to view the world as Treasury and others in the U.S. Government have always seen it. Dirty money and tainted financial flows not only corrupt the financial system but also threaten the lives of innocents and the economic and political stability of the world. Whether it is financing raised and moved to fuel terrorism or financial networks created to facilitate the proliferation of weapons of mass destruction, the global mission is clear: to disrupt and deter criminal activity that threatens our national security. In this endeavor, we must leverage all of our power to dismantle the financial infrastructure of such networks and of rogue regimes. This is now the axiom of the international community, and it is so because the U.S. Government has helped reshape the way the international community thinks about these issues.

In my testimony today, I will first explain how Treasury has helped to lead our nation's efforts in the campaign against terrorist financing and financial crime more generally. I will then describe how we have marshaled our resources over the past year to achieve significant and meaningful results against terrorist financing and other criminal networks. I will conclude by laying out some of our new initiatives, the most important of which is the establishment of the Office of Terrorism and Financial Intelligence.

During the past year, our people have worked extremely hard and achieved many significant results. At the same time, we all recognize that our enemies are sophisticated and determined, and so we must continue to adapt and revitalize ourselves so that we can continue to achieve results. This new office – which will bring together under one roof: intelligence, regulatory, law enforcement, sanctions, and policy offices – will build upon our achievements over the past year, and allow Treasury to be more effective in the war on terrorist financing and in preserving the international financial system.

II. Treasury's Role in Combating Financial Crime

The Treasury Department has traditionally had the responsibility of safeguarding the integrity of the U.S. and international financial systems from all threats. This has resulted in the Treasury Department's developing expertise in the wide range of disciplines necessary to meet that responsibility. Today, Treasury has expertise in disciplines that stretch across the entire counter-terrorist financing spectrum. These include:

- application and implementation of sanctions and administrative powers;
- direct law enforcement action and law enforcement support,
- international initiatives;
- private sector outreach and engagement; and
- financial regulation and supervision.

As reflected in Congress' decision five years ago to charge Treasury with the leading role in the development of the *National Money Laundering Strategy*, Treasury's wide range of authorities, skills and relationships makes it well-positioned to devise, coordinate, and help to implement government-wide strategies to target, attack, and dismantle the financial networks that support terrorism and other criminal activity. We take a targeted as well as a systemic approach to these complex issues, using all possible regulatory, economic, diplomatic and strategic tools and policies to ensure our systems are not abused by money launderers, terrorists and other criminals.

In an effort to consolidate these tools and policies against all elements of financial crime, one year ago the Secretary of the Treasury established the Executive Office for Terrorist Financing and Financial Crime (Executive Office). This Office is responsible for developing policies relating to the Department's anti-money laundering, terrorist financing and financial crimes mission. It also oversees the offices and Bureaus responsible for implementing and administering these policies, i.e., the Office of Foreign Assets Control (OFAC), the Financial Crimes Enforcement Network (FinCEN), and the Treasury Executive Office for Asset Forfeiture (TEOAF). It also works very closely with the Internal Revenue Service's Criminal Investigation Division (IRS-CI) which possesses unparalleled financial investigation experience.

Treasury's authorities and expertise relating to combating financial crimes may also be leveraged to accomplish financial missions of critical importance to our national security interests. This is perhaps best seen in the hunt for Iraqi assets. I would like to briefly explain our efforts in the campaign to identify and repatriate Iraqi assets as one example of how Treasury has leveraged its resources and coordinated those of the interagency community to advance a mission critical to our national security interests.

On March 20, 2003, President Bush directed the Treasury Department to a world-wide hunt for Saddam Hussein's assets and directed Treasury's newly-formed Executive Office to lead the U.S. government's efforts to find, freeze, and repatriate Iraq's money for use in the reconstruction of Iraq. Consequently, the Treasury Department established and chairs the Iraqi Assets Working Group (IAWG), comprised of all the relevant elements of this U.S. Government effort, including the National Security Council, the Departments of State, Justice, Homeland Security, Defense, and the law enforcement and intelligence communities. In this context, the Treasury Department has coordinated the intelligence and law enforcement efforts of this hunt -- relying on IRS-CI investigators and OFAC and intelligence analysts to unearth Saddam's hidden accounts and front companies around the world – and our diplomatic actions – leveraging the contacts and influence of the State Department and the Treasury abroad to gain international cooperation.

Since Secretary Snow's announcement of the campaign to identify, freeze and repatriate stolen Iraqi assets on March 20th of last year, the Treasury, working closely with other parts of the United states Government , has achieved important results in returning assets to the Iraqi people and in uncovering the schemes and networks used by the regime to steal from Iraq:

- Almost $2 billion of Iraqi assets has been newly identified and frozen outside the U.S. and Iraq;
- More than three-quarters of a billion dollars have been transferred by foreign sources to the Development Fund for Iraq (DFI). In total, the United States, foreign countries, and the Bank for International Settlements have transferred back to Iraq over $2.6 billion in frozen Iraqi funds;
- Approximately $1.3 billion in cash and valuables has been recovered in Iraq.
- We continue to identify key individuals and entities whose assets should be frozen. In the past few weeks, the Department of the Treasury has undertaken the following important actions: (i) designated 16 immediate family members of senior officials of the former Iraqi regime pursuant to Executive Order 13315; (ii) listed 191 Iraqi parastatal (quasi-governmental) entities; (iii) designated five front companies of the former Iraqi regime and four associated individuals; (iv) re-designated three other front companies and one individual previously designated by the Treasury department; and (v) through the U.S. Mission to the U.N., submitted the names of all of these entities and individuals to the United Nations, requesting that they be listed by the UN 1518 Committee under UNSCR 1483.
- In Iraq, our financial investigators from IRS-CID have conducted over 80 interviews of key individuals who have information relating to Iraqi assets, ranging from the top ministers of the State Oil Marketing Organization (SOMO), to the laborers who buried Saddam's U.S. currency. These investigators are finding and interrogating key financial facilitators like accountants and bankers, who have knowledge about the movement of

Iraqi assets. Under IRS-CI questioning, these witnesses have identified assets that can be recovered for the DFI, and which we are aggressively pursuing.

- While searching for Iraqi assets abroad, IRS-CI agents determined that the former Iraqi Ambassador to Russia had stolen $4 million in Iraqi assets that had been entrusted to him. As a result, that amount has been frozen in Russia, and we are working to have it repatriated.
- Working closely with the governments of Liechtenstein, Switzerland, and Jordan, we are attempting to recover one of Saddam's Falcon 50 corporate jets and to uncover a financial network that had been used by the Iraqis to move money and people in the heart of Europe.
- The financial investigation teams have also uncovered important leads for other IRS-CI financial investigators to follow up on in jurisdictions outside of Iraq. We have identified bank accounts and other assets held in over twenty countries, including Switzerland, France, Germany, Liechtenstein, Russia, Spain, Egypt, Thailand, Indonesia, Lebanon, Belarus, Iran, South Korea, Malaysia, Japan, Morocco, Saudi Arabia, UAE, British Virgin Islands, Jordan, Syria and Yemen.
- As a result of interagency cooperation and investigative and other efforts in Baghdad and at Headquarters, the Departments of Treasury and State have provided identifying information on over 570 identified Iraqi bank accounts to 41 countries for review and follow-up. Those accounts were identified as belonging to the Central Bank of Iraq, Rafidain Bank, and Rasheed Bank.

The identification and recovery of stolen Iraqi assets is just one area in which we have helped to drive key efforts and initiatives. This – and other Treasury initiatives – demonstrate our ability to help to coordinate government efforts and achieve positive results.

I would like to review briefly some of our successes under the U.S. Government's strategy for combating financial crime.

III. Treasury's Recent Accomplishments in Combating Financial Crime

A. Background and Strategy

Treasury's success in combating terrorist financing and financial crime reflects a strategic approach of developing and implementing policies that utilize our administrative powers, law enforcement resources, international relationships, engagement with the private sector and regulatory authorities to attack financial crime on a targeted and systemic basis. We have focused our efforts on identifying and interdicting key financial networks that support terrorist and other criminal activity, and on protecting financial systems from terrorist and criminal infiltration. Our systemic efforts are improving the transparency and accountability of financial systems around the world, making it easier to identify, disrupt and dismantle those terrorists and criminal networks that continue to abuse such systems. As we succeed in these goals, we have expanded our efforts to address alternative and informal financial systems that are vulnerable to terrorist and criminal abuse, including charities, alternative remittance systems, and cash couriers.

Targeting money flows is among the best means of tracking, exposing and capturing terrorists and their facilitators, narco-trafficking cartels and their supporting infrastructure, organized crime networks, and deposed kleptocratic regimes and their ill-gotten assets worldwide. Money flows leave a signature, an audit trail, and provide a road map of terrorist and other criminal activity. Financial investigations lead upstream to those who are generating the underlying financial crimes, as well as downstream to provide a roadmap to those financial professionals who facilitate the terrorist or criminal activity itself. As we and our international partners work together to follow and stop terrorist or illicit funds, we strengthen the integrity of our financial systems and erode the infrastructure that supports terrorists and other criminals.

B. Economic Sanctions and Administrative Powers

Treasury wields a broad range of powerful economic sanctions and administrative powers to attack various forms of financial crime. We have continued to use these authorities in the campaign against terrorist financing, drug trafficking, money laundering and other criminal financial activity.In combating terrorist financing, our primary, and most public, tool is the ability to designate terrorists and those who support terrorists, and to implement orders that freeze the assets of terrorists through Executive Order 13224. These designation actions not only prevent terrorist activity by freezing terrorist-related assets and bankrupting terrorist operations, but they also:

- identify existing terrorist activity through financial trails evident in the accounts and transactions of designated parties;
- shut down sources of and pipelines for terrorist financing;
- force terrorists to expend resources developing alternative and higher risk means of raising and moving money;
- alienate terrorist supporters from the global economy by shutting them off from the U.S. financial system and prohibiting any U.S. person from engaging in any future financial or other related services with such designated parties; and
- deter those who might otherwise be inclined to support, financially or otherwise, terrorist activities or organizations.

Through our designation actions, we have made it more difficult for terrorist groups, like al Qaida, to raise and move money around the world. Under E.O. 13224, we have designated a total of 361 individuals and entities, as well as frozen or seized approximately $200 million of terrorist-related funds worldwide. Designations under E.O. 13224 in the past year include the following:

- Ten al Qaida loyalists related to the Armed Islamic Group (GIA) on March 18
- Shaykh Abd Al-Zindani (al Qaida-related) on February 24, 2004
- Four branches of the Al Haramain Islamic Foundation (al Qaida-related) on January 22, 2004);
- Abu Ghaith (al Qaida-related) on January 16, 2004;
- Dawood Ibrahim (al Qaida-related) on October 17, 2003;
- Al Akhtar Trust International (al Qaida-related) on October 14, 2003;
- Abu Musa'ab Al-Zarqawi (al Qaida-related) on September 24, 2003;
- Yassin Sywal, Mukhlis Yunos, Imam Samudra, Huda bin Abdul Haq, Parlindungan Siregar, Julkipli Salamuddin, Aris Munandar, Fathur Rohman A1-Ghozi, Agus Dwikarna, and Abdul Hakim Murad (members of Jemaah Islamiyah) on September 5, 2003;
- Sheik Ahmed Yassin (Gaza), Imad Khalil Al-Alami (Syria), Usama Hamdan (Lebanon), Khalid Mishaal (Syria), Musa Abu Marzouk (Syna), and Abdel Aziz Rantisi (Gaza) (Hamas political leaders) on August 22, 2003;
- Comité de Bienfaisance et de Secours aux Palestiniens (France), Association de Secours Palestinien (Switzerland), Interpal (UK), Palestinian Association in Austria, and the Sanibil Association for Relief and Development (Lebanon) (all Hamas-related charities) on August 22, 2003;
- The National Council of Resistance of Iran (including its U.S. representative office and all other offices worldwide) and the People's Mujahedin Organization of Iran (including its U.S. press office and all other offices worldwide) on August 15, 2003;
- Shamil Basayev (al Qaida-related) on August 8, 2003; and
- The Al-Aqsa International Foundation (Hamas-related) on May 29, 2003.

Together with the State and Justice Departments and other agencies, we are using our diplomatic resources and regional and multilateral engagements to ensure international cooperation, collaboration and capability in designating these and other terrorist-related parties through the United Nations and around the world.

In combating drug trafficking, Treasury continues to apply its authorities under the Foreign Narcotics Kingpin Designation Act to administer and enforce the provisions of law relating to the identification and sanctioning of major foreign narcotics traffickers. The Kingpin Act, enacted in December 1999, operates on a global scale and authorizes the President to deny significant foreign narcotics traffickers, and their related businesses and operatives, access to the U.S. financial system and all trade and transactions involving U.S. companies and individuals. During 2003, the President named seven new kingpins, including two U.S.-designated foreign terrorist organizations -- Revolutionary Armed Forces of Colombia and United Self-Defense Forces of Columbia -- and a Burmese narco-trafficking ethnic guerilla army, bringing the total number designated to 38.

Since the inception of the Kingpin Act and after multi-agency consultations, Treasury has named 14 foreign businesses and 37 foreign individuals in Mexico, Colombia, and the Caribbean as derivative ("Tier II") designations. These derivative designations are flexible, and permit Treasury to attack the financial infrastructure of these kingpins as their infrastructure changes. A total of 104 organizations, individuals and businesses in 12 countries are now designated under the Kingpin Act. On February 19, 2004, Treasury designated 40 key individuals and companies associated with the Colombian narco-terrorist organizations, the FARC and the AUC. These two organizations were previously named by the President on May 29, 2003 as drug kingpins. We are currently working with the interagency community to develop a list of new designations to be issued by the President later this Spring

Another weapon that our government uses aggressively against narco-traffickers and money launderers is that of seizure and confiscation. In fiscal year 2003, Treasury's Executive Office for Asset Forfeiture (TEOAF) received over 234 million dollars in annual forfeiture revenue from the combined efforts of the former Bureau of Alcohol, Tobacco and Firearms, the U.S. Secret Service (USSS), the Internal Revenue Service (IRS), and the former U.S. Customs Service (USCS). This represents a significant increase over fiscal year 2002, in which TEOAF received over $152 million dollars of forfeiture revenue. Such an increase is particularly impressive when considering the transition undertaken by three of these law enforcement bureaus in the government reorganization last year.

In combating money laundering and financial crime generally, Treasury continues to direct its resources and coordinate efforts to administer and enforce the Bank Secrecy Act. Working through FinCEN, IRS, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and other outside agencies, Treasury administers and enforces BSA provisions relating to monetary transaction and transportation reporting and recordkeeping requirements, suspicious activity, anti-money laundering programs and other obligations as set forth in the Act.

In addition, Treasury, after appropriate interagency consultations, has applied its new authority under Section 311 of the USA PATRIOT Act (Patriot Act) to designate jurisdictions and institutions of primary money laundering concern. Most recently, we designated the jurisdiction of Burma, consistent with the Financial Action Task Force's (FATF) demand for countries to impose additional counter-measures against that country. At the same time, Treasury designated the Myanmar Mayflower Bank and Asia Wealth Bank, two Burmese banks that are linked to the United Wa State Army, a notorious drug trafficking organization in Southeast Asia. It is important to note that this is Treasury's first application of Section 311 against financial institutions. We are focused on identifying additional foreign banks that either facilitate money laundering or are otherwise involved in financial crime as potential Section 311 targets.

These accomplishments and responsibilities are just a few examples that demonstrate the wide range of economic sanctions and administrative powers that the Treasury continually applies and implements in our ongoing mission to combat financial crime.

C. Law Enforcement

In addition to these economic sanction and other administrative authorities, Treasury combats various forms of financial crime through the direct law enforcement actions of IRS-CI and the law enforcement support provided by FinCEN and Treasury's regulatory authorities.

Whether working with DEA on the money laundering component of significant drug investigations, the FBI on terrorist financing cases, or investigating offshore tax shelters and other tax-related matters, IRS-CI brings an unparalleled financial investigative expertise to the table. The financial forensic expertise of our IRS criminal investigators around the country and the world is critical in the US law enforcement community's attack on sources and schemes of terrorist financing.

A good example of our direct law enforcement action through IRS-CI is evident in our efforts to attack terrorist financing emanating from abroad. Since September of 2003, IRS-CI agents have been actively participating in a joint U.S./Saudi counterterrorism task force located in Riyadh. The Task Force both provides and receives investigative lead information on various terrorist financing matters. Additionally, the investigators seek assistance from Saudi counterparts in following terrorist financing, and using that information to identify and attack terrorist cells and operations. Information received by US agents is passed through FBI's Terrorist Financing Operations Section in Washington to the interagency JTTFs nationwide. As a part of this initiative and under the auspices of the State Department chaired Terrorist Financing Working Group, IRS-CI participated in two, week long classes of financial investigation training to Saudi Arabian criminal investigators. The courses delivered by IRS-CI included the following specialized topics: charitable entities, money laundering, net worth method of proof, expenditures method, documenting financial crimes, and computer sources of financial information. A third class will be presented this spring.

We complement such direct law enforcement action with law enforcement support. Through FinCEN, Treasury serves as a repository and analytical hub for Bank Secrecy Act information, which aids investigators across the interagency community in finding financial links to criminal enterprises and terrorist networks. Since February 2003. we have also used Section 314(a) of the Patriot Act to enable law enforcement, through FinCEN "Blastfaxes" to more than 31,800 financial institutions as of April 27, 2004, to locate quickly the accounts and transactions of those suspected of money laundering or the financing of terrorism. Since Section 314(a)'s creation, the system has been used to send the names of 1,712 persons suspected of terrorism financing or money laundering to financial institutions, and has resulted in 12,280 matches that were passed on to law enforcement. We understand the sensitivity of the use of this system, and will continue to ensure through vigorous review that this system is used only in cases where terrorist financing is suspected, or in the most egregious money laundering cases.

As a result of these efforts, FinCEN has made 342 proactive case referrals to law enforcement potentially involving terrorism based upon analysis of information in the Bank Secrecy Act database. The Terror Hotline established by FinCEN has resulted in 853 tips passed on to law enforcement since 9/11. FinCEN is also implementing an Electronic Reports program that will further enhance law enforcement's ability to utilize this information. Additionally, with the expansion of the Suspicious Activity Report (SAR) regime, as of April 28, 2004, financial institutions nationwide have filed 4,294 SARs reporting possible terrorist financing directly to FinCEN, including1,866 SARS in which terrorist financing represented a primary suspicion. This has further enhanced our efforts to identify and vigorously investigate terrorist financing webs and dismantle them.

D. International Initiatives

The success of our efforts to combat financial crime and particularly terrorist financing, depends in large part on the support of our allies and the international community. Treasury – working through the Executive Office for Terrorist Financing and Financial Crime and the Office of International Affairs – has worked with other elements of the U.S. Government to engage the international community to develop and strengthen counter-terrorist financing initiatives and regimes, and to enhance the transparency and accountability of global financial systems generally. Internationally we have received support from over 200 countries and jurisdictions, including blocking orders to freeze assets from 170 countries and jurisdictions, and other direct actions around the globe to deal with the common scourge of terrorism. We are working constantly with other governments on a bilateral, regional, and multilateral basis to focus their attention on this issue and to deal with identified risks.

We have developed and implemented a multi-pronged strategy to globalize the campaign against terrorist financing and strengthen our efforts to combat financial crime, using all of our authorities, expertise, resources and relationships with various international bodies and other governments. Our strategy includes: (i) improving global capabilities to identify and freeze terrorist-related assets; (ii) establishing or improving international standards to address identified vulnerabilities; (iii) ensuring global compliance with these standards; (iv) addressing financing mechanisms of particular concern, and (v) facilitating the sharing of information to defeat these threats.

1. Improving Global Asset-Freezing Regimes

A focal point of our international efforts to combat financial crime over the past year has been to improve the effectiveness of global asset-freezing regimes in the campaign against terrorist financing. After many months of negotiation and discussion at the FATF, we successfully developed interpretive guidance to clarify and specify international obligations and best practices in identifying and freezing terrorist-related assets. In October 2003, the FATF issued an Interpretive Note and Best Practices Paper to FATF Special Recommendation III, describing these obligations and standards. This accomplishment will provide a basis for countries to develop or reform their existing asset-freezing regimes to improve their effectiveness. We are currently using these obligations and standards to encourage necessary reforms to asset-freezing regimes in countries around the world, including our European allies. Pursuant to these efforts, the European Union is now considering adjustments to the EU Clearinghouse process used to identify and freeze terrorist-related assets across the EU. We are working with the Europeans, both bilaterally and collectively, to assist in this process.

In addition to these international public sector efforts, we are working with leading global financial institutions to develop a technical assistance initiative within the private sector to enhance capabilities in identifying and freezing terrorist-related assets. This initiative seeks to leverage existing banking expertise through bank-to-bank training, awareness and outreach.

2. Setting International Standards

Internationally, we have worked not only through the United Nations on blocking efforts, but also through multilateral organizations and on a bilateral basis to promote international standards and protocols for combating terrorist financing and financial crime generally. Such standards and protocols are essential to developing the financial transparency and accountability required to identify and attack elements of financial crime, including terrorist financing networks.

We have primarily focused our efforts to establish international standards against terrorist financing and financial crime through the FATF. The FATF is the premier international body in the international effort against money laundering and terrorist financing. Created by the G-7 in 1989, the FATF has since grown to 33 members, along with numerous observers, including the United Nations, IMF, and World Bank. The FATF's primary mission is to articulate international standards in the areas of money laundering and terrorist financing, and to work toward worldwide implementation. Treasury's Executive Office for Terrorist Financing and Financial Crime heads the U.S. delegation to the FATF and co-chairs the FATF's Working Group on Terrorist Financing.

We have worked with our counterparts in the FATF to revise the 40 Recommendations, thereby enhancing international standards of transparency and accountability required to effectively combat money laundering and other financial crimes. In June 2003, the FATF issued the revised 40 Recommendations by adding shell banks, politically-exposed persons, correspondent banking, bearer shares, the regulation of trusts, the regulation of trust and company service providers, and the regulation of lawyers and accountants. These newly revised Recommendations were endorsed by the G-7 Finance Ministers in a public statement issued the same day the revised Recommendations were adopted by FATF.

We have also capitalized on the FATF's expertise on money laundering to specifically attack terrorist financing, largely through the Eight Special Recommendations on Terrorist Financing developed and adopted by the FATF in October 2001. As co-chair to the FATF's Working Group on Terrorist Financing, the Treasury has worked closely with FATF members to issue interpretive guidance on the Eight Special Recommendations, particularly with respect to: freezing terrorist-related assets; regulating and monitoring alternative remittance systems such as hawala; ensuring accurate and meaningful originator information on cross-border wire transfers, and protecting non-profit organizations from terrorist abuse. We are currently directing the FATF's Working Group on Terrorist Financing to further attack the problem of terrorist financing through charities and cash couriers.

Through our efforts in the FATF, many countries have taken important steps to improve their legal regimes and strengthen the oversight of their financial sectors, acknowledging the need for strong anti-money laundering requirements to fight terrorist financing. Countries like Egypt, Guatemala, Indonesia, Israel, Lebanon, and the Philippines have taken important strides to develop and implement effective and comprehensive anti-money laundering regimes, strengthening their institutions and their enforcement of anti-money laundering and counter-terrorist financing laws and regulations. Treasury has played an important role in the development of anti-money laundering and counter-terrorist financing regimes in each of these countries.

Moreover, we have engaged the IMF and World Bank to gain their recognition of the FATF 40 + 8 Recommendations as one of the 12 Key International Standards and Codes. In March of this year, owing largely to the leadership of the G7, the IMF/World Bank made their AML/CFT assessment program permanent and comprehensive, thereby ensuring that all countries throughout the world are assessed against FATF standards. Additionally, Treasury, along with the State and Justice Departments, has furthered our efforts to globalize the FATF standards through our work with various FATF-style regional bodies (FSRBs). We are currently engaged in the development of two new FSRBs to cover the regions of the Middle East / North Africa and Central Asia.

3. Promoting Worldwide Implementation of International Standards

Establishing international standards is only the first step toward identifying and destroying terrorist and criminal networks and denying these groups access to the international financial system. If these standards are not implemented worldwide, terrorists and other criminals will enter the international financial system at the point of least resistance, and preventive national efforts will be rendered considerably less effective.

The United States is working together with the international community to ensure global compliance with improved international standards through a three-prong approach that includes: (i) objectively assessing all countries against the international standards; (ii) providing capacity-building assistance for key countries in need, and (iii) isolating and punishing those countries and institutions that facilitate terrorist financing.

Our federal government has identified 24 countries as priorities for receiving counter-terrorist financing technical assistance and training, and Treasury is a key supporter of the State Department-led efforts of the interagency community to work bilaterally to deliver such assistance to these priority countries.

Together with other federal government agencies and departments, we are also working with our allies in the G-8 Counter-Terrorism Action Group (CTAG) the IMF, World Bank and the FATF to coordinate bilateral and international technical assistance efforts to additional priority countries in the campaign against terrorist financing. As part of these coordinated international efforts, the FATF Working Group on Terrorist Financing has completed terrorist financing technical needs assessment reports in several priority countries. These reports will be used by the CTAG to match appropriate donor states with identified needs in each of these priority countries.

Moreover, we will continue to utilize domestic tools – including those made available through the Patriot Act -- to focus on jurisdictions that are not taking adequate steps to address terrorist financing, money laundering and other financial crimes concerns. As discussed above, Treasury is has used Section 311 of the Patriot Act to address primary money laundering concerns on a jurisdictional and institutional basis. Working in cooperation with the law enforcement and intelligence communities, we have designated three foreign jurisdictions and two financial institutions under Section 311. In addition to the Burmese designations described above, Treasury has also designated the jurisdictions of Ukraine and Nauru under Section 311. Ukraine responded to this designation almost immediately by enacting significant anti-money laundering legislation. This quick response demonstrates the power of Section 311 in promoting positive reform and addressing vulnerabilities in the international financial system. Moreover, even the possibility of a Section 311 designation can result in other nations making important changes to their legal and regulatory regimes that enhance the global anti-money laundering and anti-terrorist financing infrastructure. We will continue to seek out appropriate opportunities to utilize these new powers to protect the U.S financial system.

4. Addressing Financing Mechanisms of Particular Concern

In addition to developing and implementing broad initiatives and systemic reforms to increase the transparency and accountability of international financial systems, we have targeted specific financing mechanisms that are particularly vulnerable or attractive to terrorist financiers. These mechanisms include the abusive use of charities and NGOs, hawala and other alternative remittance or value transfer systems, wire transfers, and cash couriers, as well as trade-based money laundering and cyber-terrorist financing.

Our strategy for attacking terrorist financing and financial crime perpetrated through these mechanisms is consistent with our global strategy for combating financial crime in the formal international financial system: we will continue working domestically and with the international community to develop the transparency and accountability required to identify, disrupt and destroy terrorist financing and other criminal networks embedded in these sectors. We will also continue allocating resources to focus on high-risk elements of these sectors and concentrate our efforts on high-value targets.

To effectively counter the threat of terrorist financing through charities, we have engaged countries through the FATF to examine and analyze existing oversight mechanisms and vulnerabilities in their domestic charitable sectors. These efforts capitalize on the FATF's expertise in promoting transparency and accountability in formal financial sectors, as well as the experience gained in developing international best practices to protect charities from terrorist abuse in accordance with the FATF's Special Recommendation VIII.

We have also engaged the international community bilaterally and multilaterally to combat the threat of terrorist financing and financial crime through alternative remittance systems, such as hawala. Over the past two years, we have achieved significant progress on this issue, as reflected in the Abu Dhabi Declaration made at the conclusion of the first International Conference on Hawala in May 2002, and the adoption of interpretive guidance to FATF Special Recommendation VI in February and June of 2003. Earlier this month, Treasury led a delegation to the United Arab Emirates to continue advancing these issues in the second International Conference on Hawala.

We are also working with the international community to attack the illicit use of cash couriers by money launderers and terrorist financing networks. Treasury leads the US delegation to the Asia-Pacific Group and is working through that regional body to examine various information sharing, criminalization, and reporting mechanisms to identify and interdict the illicit use of cash couriers.

5. Facilitating International Information Sharing

Information sharing is critical to fighting terrorism and financial crime. Domestically, we have taken advantage of important information-sharing provisions of the Patriot Act to assimilate information from the financial, intelligence and law enforcement communities in identifying and attacking terrorist financing networks. To improve the global flow of financial information related to terrorist financing, we have also worked to establish and expand formal and informal, international information-sharing channels, both bilaterally and multilaterally. Through FinCEN, the U.S. Financial Intelligence Unit (FIU), we have persuaded the Egmont Group, which represents 84 FIUs from various countries around the world, to leverage its information collection, analysis and sharing capabilities to support the global war on terrorism. These ongoing efforts have greatly improved our ability to identify and unravel terrorist financing networks by tracking and tracing terrorist money trails through multiple jurisdictions.

Our efforts to combat terrorist financing and financial crime also depend upon promoting a greater understanding of the financial threats we face. To facilitate such an understanding internationally, we have worked bilaterally, regionally and globally with other governments and international bodies to develop and share case studies and typologies of financial crime, including terrorist financing.

E. Private Sector Outreach

The private sector serves as the front-line in the campaign against terrorist financing, money laundering, and other financial crime. Cooperation with the private sector, including banks and trade associations, has been essential to increasing our vigilance against the abuse of our financial system by terrorists and criminal groups. With the expansion of our anti-money laundering provisions to new segments of the financial community pursuant to the Patriot Act, we will continue and expand such cooperation by working with our domestic financial community, including banks, securities broker-dealers, mutual funds, futures commission merchants, and operators of credit card systems,[1] as well as the charitable sector outside the framework of Patriot Act regulations, to enhance their abilities to detect and report possible terrorist financing and money laundering activities.

Our ongoing outreach initiatives with the private sector promote a greater understanding of terrorist financing, money laundering and other criminal financial activity and assist us in designing effective regulations and practices to defeat these threats. We will continue to improve the effectiveness of our partnership with the private sector by: (1) increasing the amount of information the U.S. Government provides with respect to its ongoing efforts; (2) providing feedback on the usefulness of the private sector's efforts; (3) educating the private sector to recognize terrorist financing-related typologies and "red flags"; (4) reinvigorating the law enforcement-industry partnership to develop "best practices" for corporations to follow to avoid trade-based money-laundering transactions, and (5) enhancing ongoing due diligence efforts, while balancing the demands on institutions.

These goals will enhance the ability of both the public and private sectors to insulate the financial system and charitable sector from abuse, while ensuring the free flow of capital and commerce and the continued practice of charitable giving. We will advance these goals through existing mechanisms, such as the Bank Secrecy Act Advisory Group (BSAAG), and publications, such as the SAR Activity Review issued by FinCEN. In addition, Treasury officials are constantly engaged with the private financial sector on money laundering and terrorist financing issues through various conferences and meetings with trade associations and industry professionals, both domestically and internationally. We will continue to take advantage of these opportunities whenever and wherever possible to advance our partnership with the private sector in combating financial crime.

Treasury is also engaged in sustained outreach with the charitable sector. In

November 2002, the Treasury Department issued *Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities* to enhance donor awareness of the kinds of practices that charities may adopt to reduce the risk of terrorist financing. Since then, Treasury officials have participated in several conferences within the charitable sector to explain these Guidelines and new developments in the campaign against terrorist financing. Earlier this week, the Treasury Department hosted an outreach event with representatives from approximately 30 charitable organizations to further explain and discuss the Guidelines and developments related to terrorist abuse of the charitable sector. We anticipate conducting similar outreach meetings with the charitable sector to continue advancing our collective interests in facilitating charitable giving by protecting charitable funds from terrorist abuse.

F. Regulation and Supervision

We have taken many steps to investigate and regulate sectors that offer opportunities for terrorists and other criminals to raise and move funds. Through outreach efforts such as those described above, we have built relationships with the private sector to enlist their support in broadening and deepening the regulatory structure and reporting requirements in the domestic financial system. We are creating a level-playing field and attacked money laundering and terrorist financing through non-banking financial systems under the Patriot Act, subjecting new sectors of the economy (the securities and futures industries) to anti-money laundering controls like record-keeping and reporting requirements previously imposed primarily on banks.

In addition to the successful implementation and applications of Sections 314(a) and 311 as discussed above, a recent example of our implementation of the Patriot Act is Section 326. This provision mandates basic, uniform customer identification and verification procedures for individuals and businesses that open accounts with banks (including thrifts and credit unions), securities brokers, mutual funds, and future commission merchants.

IV. The Future of Treasury's Efforts in the Battle against Terrorist Financing and Financial Crimes

The efforts and accomplishments of the past year have shown two things. First, the Treasury Department plays and must continue to play a critical role in driving national policies related to terrorist financing, money laundering, financial crimes, and economic sanctions. The is well placed – given its authorities, expertise, and contacts – to deal with issues that cut across several disciplines and require concerted attention to identify and interdict tainted financial flows. Second, these efforts have to be improved, amplified, and supported because of their growing importance at home and abroad.

we have had real success in fighting this war, but as the recent bombings in Madrid and Riyadh demonstrate, there is no end to our work. Our enemies are numerous, resourceful, and dedicated, and they continually adapt to the changing environment. We must do the same. We can and must do more – using every tool that we have. We must also recognize that -- unfortunately -- we are in this fight for the long term -- and so the Department needs to be organized to reflect that reality.

This is precisely why the Administration has collaborated with Congress and this Committee to develop a new Treasury structure -- a high profile office led by an Under Secretary -- one of only three in the Department -- and two Assistant Secretaries. It is an office that will bring together Treasury's intelligence, regulatory, law enforcement, sanctions, and policy components.

I want to specifically note the important contributions made by the Chairman and Ranking Member of this Committee, which resulted in an exchange of letters with Secretary Snow at the end of last year. I also want to thank the Congress for establishing the new Assistant Secretary for Intelligence position. Since that time, the Administration has worked hard to implement the concepts described in those letters.

On March 8th, 2004, Treasury formally announced the creation of this office, entitled the Office of Terrorism and Financial Intelligence (TFI) in the Department of the Treasury. On March 10th, the President announced that he would nominate Stuart Levey, currently the Principal Associate Deputy Assistant Attorney General, for the Under Secretary position, and Juan Zarate, currently the Deputy Assistant Secretary in charge of terrorist financing at Treasury, for one of the two Assistant Secretary positions. Both of those nominations have since been transmitted to the Senate. We are working diligently to identify the most qualified individual to serve as the Assistant Secretary for Intelligence. In the meantime, we have appointed a very capable Deputy Assistant Secretary to get this office up and running.

The creation of TFI will redouble Treasury's efforts in at least four specific ways. First, it will allow us to better develop and target our intelligence analysis and financial data to detect how terrorists are exploiting the financial system and to design methods to stop them. TFI will be responsible for producing tailored products to support the Treasury Department's contributions to the war against terrorist financing. Second, it will allow us to better coordinate an aggressive enforcement program, including the use of important new tools that the Patriot Act gave to Treasury. Third, it will help us continue to develop the strong international coalition to combat terrorist financing. A unified structure will promote a robust international engagement and allow us to intensify outreach to our counterparts in other countries. Fourth, it will ensure accountability and help achieve results for this essential mission.

TFI will have two major components. An Assistant Secretary will lead the Office of Terrorist Financing. The Office of Terrorist Financing will build on the functions that have been underway at Treasury over the past year. In essence, this will be the policy and outreach apparatus for the Treasury Department on the issues of terrorist financing, money laundering, financial crime, and sanctions issues. The office will help to lead and integrate the important functions of OFAC and FinCEN.

This office will continue to assist in developing, organizing, and implementing U.S. government strategies to combat these issues of concern, both internationally and domestically. This will mean increased coordination with other elements of the U.S. government, including law enforcement and regulatory agencies. This office will continue to represent the United States at international bodies dedicated to fighting terrorist financing and financial crime such as the Financial Action Task Force and will increase our multilateral and bilateral efforts in this field. We will use this office to create global solutions to these evolving international problems. In this regard, we will also have a more vigorous role in the implementation of measures that can affect the behavior of rogue actors abroad.

Domestically, this office will be charged with continuing to develop and implement the money laundering strategies as well as other policies and programs to fight financial crimes. It will continue to develop and help implement our policies and regulations in support of the Bank Secrecy Act and the Patriot Act. We will further increase our interaction with federal law enforcement and continue to work closely with the Criminal Investigators at the IRS – including integration of their Lead Development Centers, such as the one in Garden City, New York – to deal with emerging domestic and international financial crimes of concern. Finally, this office will serve as a primary outreach body – to the private sector and other stakeholders – to ensure that we are maximizing the effectiveness of our efforts.

A second Assistant Secretary will lead the Office of Intelligence and Analysis. In determining the structure of OIA, we have first focused on meeting our urgent short-term needs. We have assembled a team of analysts to closely monitor and review current intelligence threat reporting. These analysts, who are sitting together in secure space in the Main Treasury building, are ensuring that Treasury can track, analyze any financial angles, and then take any appropriate action to counter these threats. Treasury will make sure to coordinate with all relevant agencies, including the Terrorist Threat Integration Center (TTIC).

In the near term, the Department plans to further develop our analytical capability in untapped areas, such as strategic targeting of terrorist financial networks and their key nodes. We also plan to analyze trends and patterns and non-traditional targets such as hawalas and couriers. In order to accomplish these goals, we plan to hire several new analysts as well as to draw on additional resources from OFAC and FinCEN. The precise number of analysts has yet to be determined -- as we are still ensuring that we have the proper leadership in place and that we do not disrupt our important ongoing efforts. Certain specifics, such as the physical location of the analysts, will be determined by a number of factors, including expertise, skills mix, and lessons learned as we go.

This Assistant Secretary will focus on enhancing the Department's relations with the intelligence community -- making sure that we are not duplicating the efforts of other agencies, but instead, are filling any gaps in intelligence targets. Ultimately, we envision that all of Treasury's intelligence analysis will be coordinated through the Office of Intelligence and Analysis. This will include intelligence support for Treasury's senior leadership on the full range of political and economic issues

We are currently confronting the question of staffing and funding for TFI. As Secretary Snow wrote in an April 16th letter to Members of Congress, President Bush has proposed significant spending increases in his Fiscal Year 2005 Budget to continue the fight against terror financing and financial crimes. The Secretary also stated that the Department would use currently appropriated Fiscal Year 2004 resources to ensure that TFI has the necessary resources to staff the new offices, as well as to bolster capabilities of existing functions.

I am able to provide some more detail today about those issues. We believe that through a combination of prudent and targeted use of resources, Treasury will be able to spend up to an additional $2 million on staffing and other start-up needs of TFI during the rest of the current fiscal year. We anticipate that we will be able to bring on board up to 15 new personnel during the remainder of the fiscal year.

Looking forward to the next fiscal year, we have not made firm decisions about how much money we will devote to the new office. We will evaluate our needs, and we are prepared to make the hard decisions about how to allocate our limited resources. Fighting the war on terror is a priority of the President and of this Department -- and we will spend whatever we need to carry out our duties in a responsible manner. And, of course, we will work with the Congress in making those decisions.

As can be seen from the description above, TFI will enhance the Treasury Department's ability to meet our own mission and to work cooperatively with our partners in the law enforcement and intelligence communities. We are confident that TFI will compliment and not duplicate the important work being done by the Department of Justice and Department of Homeland Security, and by the various intelligence agencies, and will be fully integrated into already established task forces and processes.

President Bush and this entire Administration are firmly committed to waging a relentless war on terrorists and those who offer them support. Our fight is guided by 5 goals.

- To leverage all of the government's assets to identify and attack the financial infrastructure of terrorist groups;
- To focus Treasury's powers on identifying and addressing vulnerabilities in domestic and international financial systems, including informal financial systems;
- To direct our government's efforts on financial missions of critical importance to our national security interests, such as proliferation finance and identifying and recovering stolen Iraqi assets;
- To promote a stronger partnership with the private financial sector by sharing more complete and timely information;
- To improve domestic and international coordination and collaboration by combating financial crime by increasing the frequency and value of financial information shared across our government and with other governments.

These goals are critical to protecting and promoting our national security interests.

The new office of TFI will improve our ability to advance these goals by further consolidating Treasury's unique assets in the campaign against financial crime, and by integrating and coordinating these assets with those of the interagency community.

I look forward to continuing to work with the Congress and this Committee in the creation of TFI and in advancing our mission in the war on terrorism and financial crime.

-30-

[1] The list also includes insurance companies; money order and traveler's check issuers and redeemers; check cashers; wire remitters; currency exchangers; and a myriad of other non-bank financial institutions.

federal financing bank NEW

WASHINGTON, D.C. 20220

FEDERAL FINANCING BANK

2004 PRESS RELEASE

April 2004

Brian D. Jackson, Chief Financial Officer, Federal Financing Bank (FFB) announced the following activity for the month of April 2004.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $29.4 billion on April 30, 2004, posting a decrease of $695.3 million from the level on March 31, 2004. This net change was the result of decreases in holdings of agency debt (U.S. Postal Service) of $873.6 million and in holdings of agency assets of $75.0 million, and an increase in net holdings of government-guaranteed loans of $253.3 million. The FFB made 68 disbursements and received 4 prepayments during the month of April.

Below are tables presenting FFB April 2004 loan activity and FFB holdings as of April 30, 2004.

PRINT

FEDERAL FINANCING BANK
April 2004 ACTIVITY

Borrower	*Date*	*Amount of Advance*	*Final Maturity*	*Interest Rate*	*Semi-Annually or Quarterly*
AGENCY DEBT					
U.S. POSTAL SERVICE					
U.S. Postal Service	3/01	$1,500,000,000.00	3/2/2004	1.092%	Semi-Annually
U.S. Postal Service	3/01	$88,200,000.00	3/2/2004	1.091%	Semi-Annually

JS - 1502

U.S. Postal Service	3/02	$1,200,000,000.00	3/3/2004	1.071%	Semi-Annually
U.S. Postal Service	3/02	$79,800,000.00	3/3/2004	1.109%	Semi-Annually
U.S. Postal Service	3/03	$950,000,000.00	3/4/2004	1.091%	Semi-Annually
U.S. Postal Service	3/03	$129,800,000.00	3/4/2004	1.099%	Semi-Annually
U.S. Postal Service	3/04	$750,000,000.00	3/5/2004	1.109%	Semi-Annually
U.S. Postal Service	3/04	$89,200,000.00	3/5/2004	1.099%	Semi-Annually
U.S. Postal Service	3/05	$650,000,000.00	3/8/2004	1.099%	Semi-Annually
U.S. Postal Service	3/08	$372,200,000.00	3/9/2004	1.079%	Semi-Annually
U.S. Postal Service	3/09	$77,200,000.00	3/10/2004	1.109°s	Semi-Annually
U.S. Postal Service	3/12	$700,000,000.00	3/15/2004	1.099%	Semi-Annually
U.S. Postal Service	3/12	$159,800,000.00	3/15/2004	1.089%	Semi-Annually
U.S. Postal Service	3/15	$1,000,000,000.00	3/16/2004	1.089%	Semi-Annually
U.S. Postal Service	3/15	$149,100,000.00	3/16/2004	1.068%	Semi-Annually
U.S. Postal Service	3/16	$750,000,000.00	3/17/2004	1.089%	Semi-Annually
U.S. Postal Service	3/16	$156,900,000.00	3/17/2004	1.099%	Semi-Annually
U.S. Postal Service	3/17	$600,000,000.00	3/18/2004	1.068%	Semi-Annually
U.S. Postal Service	3/17	$138,700,000.00	3/18/2004	1.069%	Semi-Annually
U.S. Postal Service	3/18	$400,000,000.00	3/20/2004	1.099%	Semi-Annually
U.S. Postal Service	3/18	$165,600,000.00	3/20/2004	1.058%	Semi-Annually
U.S. Postal Service	3/20	$400,000,000.00	3/22/2004	1.069%	Semi-Annually
U.S. Postal Service	3/20	$88,300,000.00	3/22/2004	1.058%	Semi-Annually
U.S. Postal Service	3/22	$458,300,000.00	3/23/2004	1.068%	Semi-Annually
U.S. Postal Service	3/23	$216,100,000.00	3/24/2004	1.089%	Semi-Annually
U.S. Postal Service	3/24	$28,600,000.00	3/25/2004	1.079%	Semi-Annually
U.S. Postal Service	3/26	$750,000,000.00	3/29/2004	1.079%	Semi-Annually
U.S. Postal Service	3/26	$188,000,000.00	3/29/2004	1.069%	Semi-Annually
U.S. Postal Service	3/29	$1,000,000,000.00	3/30/2004	107.900%	Semi-Annually
U.S. Postal Service	3/29	$272,200,000.00	3/30/2004	1.079%	Semi-Annually
U.S. Postal Service	3/30	$900,000,000.00	3/31/2004	1.069%	Semi-Annually
U.S. Postal Service	3/30	$121;700;000.00	3/31/2004	1.099%	Semi-Annually
U.S. Postal Service	3/31	$1,300,000,000.00	4/1/2004	1.079%	Semi-Annually
U.S. Postal Service	3/31	$193,800,000.00	4/1/2004	1.089%	Semi-Annually
GOVT-GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
San Francisco Bldg Lease	3/10	$3,709,981.18	8/O1/05	1.409%	Semi-Annually
San Francisco OB	3/18	$121,559.04	8/1/2005	1.430%	Semi-Annually
San Francisco OB	3/20	$132,507.93	8/1/2005	0.014%	Semi-Annually
Foley Square Office Bldg.	3/24	$181,609.00	7/31/2025	427.700%	Semi-Annually
Daviess-Martin County #670	3/16	$100,000.00	1/2/2035	4.504%	Quarterly
PRTCommunications #798	3/16	$773,159.00	6/30/2004	0.971%	Quarterly

East Central Energy #825	3/17	$598,000.00	12/31/2036	4.481%	Quarterly
North Central Elec Coop. #2015	3/17	$800,000.00	12/31/2036	4.482%	Quarterly
Union Electric #783	3/17	$10;000,000.00	12/31/2024	4.074%	Quarterly
McLeod Coop. Power #554	3/20	$819,000.00	6/30/2004	0.937%	Quarterly
S. Illinois Power #818	3/20	$9,524,000.00	1/3/2034	4.466%	Quarterly
Fox Islands Elec. Coop. #2106	3/22	$45,000.00	12/31/2037	4.576%	Quarterly
A & N Electric #868	3/25	$1,190,000.00	12/31/2036	4.493%	Quarterly
Harrison County rural #609	3/25	$475,000.00	6/30/2014	3.647%	Quarterly
Harrison County rural #609	3/25	$225,000.00	1/3/2034	4.427%	Quarterly
North Carolina RSA 3 Tel #2009	3/26	$5,559,827.00	6/30/2004	0.935%	Quarterly
Tri-County Elec. Coop. #646	3/26	$5,000,000.00	1/2/2035	4.482%	Quarterly
Cornbelt Power #2099	3/30	$15,719,000.00	1/3/2033	4.433%	Quarterly
Cornbelt Power #2099	3/30	$2,004,000.00	1/3/2033	4.433%	Quarterly
Peoples Cooperative Svcs #2024	3/30	$1,000,000.00	12/31/2036	4.658%	Quarterly
Runestone Electric Ass. #886	3/30	$350,000.00	6/30/2004	0.965%	Quarterly
Southeastern Indiana #2062	3/30	$3,700,000.00	6/30/2004	0.964%	Quarterly
*Adams Rural Electric #706	3/31	$493,105.59	6/30/2004	0.955%	Quarterly
*Adams Rural Electric #706	3/31	$493,316.96	6/30/2004	0.955%	Quarterly
*Adams Rural Electric #706	3/31	$639,606.87	6/30/2004	0.955%	Quarterly
*Amicalola Electric #664	3/31	$4,808,948.60	6/30/2004	0.955%	Quarterly
*Amicalola Electric #664	3/31	$6,679,167.99	6/30/2004	0.955%	Quarterly
*Atlantic Telephone Mem. #805	3/31	$5,696,143.18	6/30/2004	0.955%	Quarterly
*Bailey County Elec. #856	3/31	$1,883,701.90	6/30/2004	0.955%	Quarterly
*Bailey County Elec. #856	3/31	$611,010.91	6/30/2004	0.955%	Quarterly
*Basin Electric #425	3/31	$12,407,829.27	6/30/2004	1.080%	Quarterly
*Basin Electric #2005	3/31	$3,000,000.00	6/30/2004	0.955%	Quarterly
*Big Sand Elec. #540	3/31	$747,904.02	6/30/2004	0.955%	Quarterly
*Big Sand Elec. #540	3/31	$560,928.01	6/30/2004	0.955%	Quarterly
*Big Sand Elec. #540	3/31	$937,749.83	6/30/2004	0.955%	Quarterly
*Big Sand Elec. #540	3/31	$2,180,959.00	6/30/2004	0.955%	Quarterly
*Big Sand Elec. #540	3/31	$2,724,510.71	6/30/2004	0.955%	Quarterly
*Blue Grass Energy #674	3/31	$4,811,869.63	6/30/2004	0.955%	Quarterly
*Blue Grass Energy #674	3/31	$1,922,354.35	6/30/2004	0.955%	Quarterly
*Blue Grass Energy #674	3/31	$4,898,561.11	6/30/2004	0.955%	Quarterly
*Brazos Electric #844	3/31	$4,403,252.55	6/30/2004	0.955%	Quarterly
*Brazos Electric #844	3/31	$4,967,568.31	6/30/2004	0.955%	Quarterly
*Brazos Electric #844	3/31	$4,967,568.31	6/30/2004	0.955%	Quarterly
*Brazos Electric #844	3/31	$4,967,568.31	6/30/2004	0.955%	Quarterly
*Brown County Elec. #687	3/31	$238,877.84	6/30/2004	0.955%	Quarterly
*Brown County Elec. #687	3/31	$573,306.85	6/30/2004	0.955%	Quarterly
*Brown County Elec. #687	3/31	$286,699.63	6/30/2004	0.955%	Quarterly

*Central Texas Elec. #520	3/31	$1,897,493.54	1/3/2033	4.703%	Quarterly
*Clark Energy Coop. #611	3/31	$2,813,249.46	6/30/2004	0.955%	Quarterly
*Clark Energy Coop. #611	3/31	$1,869,475.14	6/30/2004	0.955°%	Quarterly
*Clark Energy Coop. #611	3/31	$4,172,102.03	6/30/2004	0.955%	Quarterly
*Clark Energy Coop. #611	3/31	$3,489,111.29	6/30/2004	0.955%	Quarterly
*Clark Energy Coop. #611	3/31	$2,527,317.83	6/30/2004	0.955%	Quarterly
*Cumberland Valley #668	3/31	$4,013,147.94	6/30/2004	0.955%	Quarterly
*Cumberland Valley #668	3/31	$4,819,784.97	6/30/2004	0.955%	Quarterly
*Cooper Valley Tel. #648	3/31	$942,787.77	6/30/2004	0.955%	Quarterly
*Cooper Valley Tel. #648	3/31	$214,530.58	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$1,723,346.54	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	-$396-;993.19	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$191,343.57	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$226,214.58	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$164,519.69	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$244,097.16	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$201,002.15	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$1,365,929.31	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$254,830.05	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$502,845.66	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$366,264.08	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$453,907.88	6/30/2004	0.955%	Quarterly
*Darien Telephone Co. #719	3/31	$637,288.55	6/30/2004	0.955%	Quarterly
*Delaware County Elec. #682	3/31	$630,724.60	1/2/2035	4.622%	Quarterly
*East River Power #453	3/31	$363,515.91	6/30/2004	1.080%	Quarterly
*East River Power #453	3/31	$179,274.97	6/30/2004	1.080°%	Quarterly
*East River Power #601	3/31	$3,131,854.14	6/30/2004	0.955%	Quarterly
*East River Power #793	3/31	$615,824.78	6/30/2004	0.955%	Quarterly
East Mississippi Elec. #740	3/31	$3,000,000.00	12/31/2030	4.523%	Quarterly
*Fairfield Elec. #684	3/31	$3,089,873.72	6/30/2004	0.955%	Quarterly
*Farmer's Rural Elec. #2046	3/31	$5,000,000.00	6/30/2004	0.955%	Quarterly
*Farmer's Rural Elec. #2046	3/31	$1,000,000.00	6/30/2004	0.955%	Quarterly
*Farmer's Telephone #459	3/31	$20,362.99	6/30/2004	1.080%	Quarterly
*Farmer's Telephone #459	3/31	$193,715.90	6/30/2004	1.080%	Quarterly
*Fleming-Mason Energy #644	3/31	$2,438,149.53	6/30/2004	0.955%	Quarterly
*Fleming-Mason Energy #644	3/31	$1,312,849.72	6/30/2004	0.955%	Quarterly
*Fleming-Mason Energy #644	3/31	$1,406,624.73	6/30/2004	0.955%	Quarterly
*Fleming-Mason Energy #644	3/31	$2,063,049.59	6/30/2004	0.955%	Quarterly
*Fleming-Mason Energy #644	3/31	$1,312,849.72	6/30/2004	0.955%	Quarterly
*Fleming-Mason Energy #644	3/31	$2,844,720.57	6/30/2004	0.955%	Quarterly
*Fleming-Mason Energy #644	3/31	$2,819,142.50	6/30/2004	0.955%	Quarterly

*Fleming-Mason Energy #644	3/31	$2,978,732.39	6/30/2004	0.955%	Quarterly
*Freeborn-Mower Coop. #736	3/31	$720,806.08	6/30/2004	0.955%	Quarterly
*Freeborn-Mower Coop. #736	3/31	$480,551.52	6/30/2004	0.955%	Quarterly
*Farmers Telephone #476	3/31	$9,143,703.08	6/30/2004	1.080%	Quarterly
*Farmers Telephone #476	3/31	$6,811,406.12	6/30/2004	1.080%	Quarterly
*Farmers Telephone #476	3/31	$5,289,426.15	6/30/2004	1.080%	Quarterly
*FTC Communications #709	3/31	$2,451,387.40	6/30/2004	0.955%	Quarterly
*FTC Communications #709	3/31	$3,135,098.34	6/30/2004	0.955%	Quarterly
*FTC Communications #709	3/31	$1,104,808.61	6/30/2004	0.955%	Quarterly
*Goodhue County #672	3/31	$404,517.32	1/2/2035	4.622%	Quarterly
*Grady Electric #690	3/31	$3,038,965.40	6/30/2004	0.955%	Quarterly
*Grady Electric #746	3/31	$3,145,798.60	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$1,125,299.79	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$562,649.90	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$937,749.83	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$1,214,883.75	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$959,632.93	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$2,430,291.70	6/30/2004	0.955%	Quarterly
*Grayson Rural Elec. #619	3/31	$992,910.80	6/30/2004	0.955%	Quarterly
*Greenbelt Elec. #743	3/31	$1,693,755.56	6/30/2004	0.955%	Quarterly
*Greenbelt Elec. #743	3/31	$488x939.21	6/30/2004	0.955%	Quarterly
*Grundy Elec.Coop. #744	3/31	$1,209,922.54	6/30/2004	0.955%	Quarterly
*Grundy Elec.Coop. #744	3/31	$968,068.36	6/30/2004	0.955%	Quarterly
*Grundy Elec.Coop. #744	3/31	$493,362.28	6/30/2004	0.955%	Quarterly
*Grundy County Elec. #689	3/31	$198,622.33	6/30/2004	0.955%	Quarterly
*Harrison County #532	3/31	$933,936.28	6/30/2004	0.955%	Quarterly
*Harrison County #532	3/31	$840,542.66	6/30/2004	0.955%	Quarterly
*Harrison County #532	3/31	$940,237.24	6/30/2004	0.955%	Quarterly
*Harrison County #532	3/31	$1,533,207.74	6/30/2004	0.955%	Quarterly
*Harrison County #532	3/31	$1,650,685.19	6/30/2004	0.955%	Quarterly
*Hudson Valley Datanet #833	3/31	$4,927,429.95	6/30/2004	0.955%	Quarterly
*Hudson Valley Datanet #833	3/31	$3,591,000.00	6/30/2004	0.955%	Quarterly
*Hudson Valley Datanet #833	3/31	$1,970,971.98	6/30/2004	0.955%	Quarterly
*Inter-County Energy #592	3/31	$1,400,904.41	6/30/2004	0.955%	Quarterly
*Inter-County Energy #592	3/31	$1,867,872.56	6/30/2004	0.955%	Quarterly
*Inter-County Energy #592	3/31	$2,434,771.88	6/30/2004	0.955%	Quarterly
*Inter-County Energy #592	3/31	$207,242.70	6/30/2004	0.955%	Quarterly
*Inter-County Energy #850	3/31	$3,974,054.65	6/30/2004	0.955%	Quarterly
*Inter-County Energy #850	3/31	$1,987,027.32	6/30/2004	0.955%	Quarterly
*Inter-County Energy #850	3/31	$1,987,152.13	6/30/2004	0.955%	Quarterly
*Jackson Energy #794	3/31	$3,895,930.01	6/30/2004	0.955%	Quarterly

*Jackson Energy #794	3/31	$2,921,947.50	6/30/2004	0.955%	Quarterly
*Jackson Energy #794	3/31	$4,577,717.76	6/30/2004	0.955%	Quarterly
*Jackson Energy #794	3/31	$1,947,965.01	6/30/2004	0.955%	Quarterly
*Jackson Energy #794	3/31	$2,434,956.25	6/30/2004	0.955°s	Quarterly
*Jackson Energy #794	3/31	$1,948,024.09	6/30/2004	0.955%	Quarterly
*Jackson Energy #794	3/31	$7,251,936.34	6/30/2004	0.955%	Quarterly
*Johnson County E1ec. #482	3/31	$1,497,488.66	6/30/2004	1.080%	Quarterly
*Kenergy Corp. #2068	3/31	$6,000,000.00	6/30/2004	0.955%	Quarterly
*Licking Valley Elec. #522	3/31	$2,567,390.83	6/30/2004	0.955%	Quarterly
*Licking Valley Elec. #854	3/31	$2,000,000.00	6/30/2004	0.955%	Quarterly
*Magnolia Electric #560	3/31	$4,677,707.61	6/30/2004	1.080%	Quarterly
*Medina Electric #622	3/31	$1,443,419.78	3/31/2006	1.617%	Quarterly
*Medina Electric #622	3/31	$1,449,972.16	3/31/2006	1.617%	Quarterly
*North Carolina RSA 3 Tel #2009	3/31	$9,600,000.00	6/30/2004	0.955%	Quarterly
*New Horizon Elec. #791	3/31	$2,019,297.75	6/30/2004	0.955%	Quarterly
*New Horizon Elec. #791	3/31	$1,365,554.86	6/30/2004	0.955%	Quarterly
*New Horizon Elec. #791	3/31	$1,674,002.46	6/30/2004	0.955%	Quarterly
*New Horizon Elec. #791	3/31	$1,026,642.07	6/30/2004	0.955%	Quarterly
*Noun Rural Elec. #528	3/31	$1,767,941.36	6/30/2004	0.955%	Quarterly
*Noun Rural Elec. #577	3/31	$2,412,357.43	6/30/2004	0.955%	Quarterly
*Noun Rural Elec. #577	3/31	$2,412,357.43	6/30/2004	0.955%	Quarterly
*Noun Rural Elec. #840	3/31	$3,974,054.65	6/30/2004	0.955%	Quarterly
*Noun Rural Elec. #840	3/31	$2,928,878.27	6/30/2004	0.955%	Quarterly
*Northstar Technology #811	3/31	$1,756,119.83	6/30/2004	0.955%	Quarterly
*Northstar Technology #811	3/31	$957,800.65	6/30/2004	0.955%	Quarterly
*Oglethorpe Power #445	3/31	$13,621,742.21	1/2/2024	4.208%	Quarterly
*Owen Electric #525	3/31	$1,870,480.43	6/30/2004	0.955%	Quarterly
*Owen Electric #525	3/31	$1,866,702.96	6/30/2004	0.955%	Quarterly
*Owen Electric #525	3/31	$941,785.51	6/30/2004	0.955%	Quarterly
*Owen Electric #525	3/31	$1;899;216.97	6/30/2004	0.955%	Quarterly
*Owen Electric #525	3/31	$1,935,111.20	6/30/2004	0.955%	Quarterly
*Pennyrile Elec. #513	3/31	$5,717,873.97	6/30/2004	1.080%	Quarterly
*Pennyrile Elec. #513	3/31	$5,412,652.01	6/30/2004	1.080%	Quarterly
*PRTCommunications #798	3/31	$4,644,329.38	6/30/2004	0.955%	Quarterly
*PRTCommunications #798	3/31	$1,740,898.15	6/30/2004	0.955%	Quarterly
*Runestone Electric Ass. #886	3/31	$1,500,000.00	6/30/2004	0.955%	Quarterly
*San Miguel Electric #919	3/31	$7,043,290.13	6/30/2004	0.955%	Quarterly
*San Miguel Electric #919	3/31	$7,395,537.05	6/30/2004	0.955%	Quarterly
*Southeastern Indiana #2062	3/31	$2,650,000.00	6/30/2004	0.955%	Quarterly
*Southeastern Indiana #2062	3/31	$2,650,000.00	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$917,958.27	6/30/2004	0.955%	Quarterly

*Surry-Yadkin Elec. #534	3/31	$917,958.27	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$458,979.14	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534 3/31	3/31	$917,958.27	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534 3/31	3/31	$917,958.27	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534 3/31	3/31	$933,008.72	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534 3/31	3/31	$939,082.61	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #534 3/31	3/31	$2,169,366.29	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #852 3/31	3/31	$1,000,000.00	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #852 3/31	3/31	$2,000,000.00	6/30/2004	0.955%	Quarterly
*Surry-Yadkin Elec. #852 3/31	3/31	$500,000.00	6/30/2004	0.955%	Quarterly
*Thumb Electric #767	3/31	$393,053.85	3/31/2034	4.641%	Quarterly
*Thumb Electric #767	3/31	$493,355.78	3/31/2034	4.641%	Quarterly
*Thumb Electric #767	3/31	$616,687.69	6/30/2004	0.955%	Quarterly
*United Elec. Coop. #870 3/31	3/31	$12,000,000.00	6/30/2004	0.955%	Quarterly
*United Elec. Coop. #870 3/31	3/31	$3,000,000.00	6/30/2004	0.955%	Quarterly
*Upsala Coop. Tele. #429 3/31	3/31	$229,830.52	1/2/2018	3.810%	Quarterly
*Virgin Islands Telephone #2089 3/31	3/31	$64,655,000.00	6/30/2004	0.955%	Quarterly
*Webster Electric #705 3/31	3/31	$2,119,681.86	6/30/2004	0.955%	Quarterly
*West Plains Elec. #501 3/31	3/31	$2,199,220.17	6/30/2004	1.080%	Quarterly

Return To top

FEDERAL FINANCING BANK HOLDINGS
April 2004
(in millions of dollars)

'rogram	*April 30, 2004*	*March 31, 2004*	*Monthly Net Change 4/1/04- 4/30/04*	*Fiscal Year Net Change 10/1/03- 4/3(*
gency Debt: .S. Postal Service	$620.20	$1,493.80	($873.60)	($6,653
Subtotal*	$620.20	$1,493.80	($873.60)	($6,653
gency Assets:				
nHA-RDIF	$515.00	$590.00	($75.00)	($290
nHA-RHIF	$1,830.00	$1,830.00	$0.00	$(
ural Utilities Service-CBO	$4,270.20	$4,270.20	$0.00	$(
Subtotal*	$6,615.20	$6,690.20	($75.00)	($290
overnment-Guaranteed Lending:				
OD-Foreign Military Sales	$1,572.50	$1,575.20	($2.70)	($115
oEd-HBCU+	$126.60	$126.10	$0.50	$4'

DHUD-Community Dev. Block Grant	$1.00	$1.00	$0.0	($1
DHUD-Public Housing Notes	$1,054.80	$1,054.80	$0.00	($78
General Services Administration+	$2,142.30	$2,139.20	$3.10	($4
DOI-Virgin Islands	$8.20	$8.20	$0.00	($1
DON-Ship Lease Financing	$597.30	$597.30	$0.00	($10
Rural Utilities Service	$16,626.50	$16,372.70	$253.90	$1,00
SBA-State/Local Development Cos.	$65.20	$66.60	($1.40)	($12
DOT-Section 511	$3.00	$3.00	$0.00	($0
Subtotal*	$22,197.40	$21,944.00	$253.30	$83
Grand total*	$29,432.80	$30,128.00	($695.30)	($6,111

figures may not total due to rounding; +does not include capitalized interest

Return To top

2004 Press Releases

Return to All PRESS RELEASES

Last Updated on 6/10/04

Bureau of the
Public Debt
United States Department of the Treasury

BONDS TO EARN 3.39% WHEN BOUGHT FROM MAY THROUGH OCTOBER 2004

OR RELEASE AT 10:00 AM EST

ay 3, 2004

BOND EARNINGS RATE 3.39%

ıe earnings rate for I Bonds is a combination of a fixed rate, which will apply for the life of the bond, and the inflation rate. The 3.39 ɘrcent earnings rate for I Bonds bought from May through October 2004 will apply for the first six months after their issue. The earnings te combines the 1.0 percent fixed rate of return with the 2.38 percent annualized rate of inflation as measured by the Consumer Price dex for all Urban Consumers (CPI-U). The CPI-U increased from 185.2 to 187.4 from September 2003 to March 2004, a six-month crease of 1.19 percent.

easury's inflation-indexed I Bonds are designed to offer all Americans a way to save that protects the purchasing power of their vestment by assuring them a real rate of return above inflation. I Bonds have features that make them attractive to many investors. ıey are sold at face value in denominations of $50, $75, $100, $200, $500, $1,000, $5,000, and $10,000 and earn interest for as long 30 years. I Bond earnings are added every month and interest is compounded semiannually. They are State and local income tax :empt, and Federal income tax on I Bond earnings can be deferred until the bonds are cashed or they stop earning interest after 30 ars. Investors cashing I Bonds before five years are subject to a 3-month earnings penalty.

ıvers and investors can now open an on-line account to purchase I Bonds in electronic form through the website vw.treasurydirect.gov. Account holders can purchase, manage, and redeem such I Bonds over the Internet 24 hours a day, seven days week. These rates also apply to electronic I Bonds.

3OND FIXED RATE 1.0%

:ries I, inflation-indexed savings bonds purchased from May through October 2004 will earn a 1.0 percent fixed rate of return above lation. The 1.0 percent fixed rate applies for the 30-year life of I Bonds purchased during this six-month period.

ıRNINGS RATES FOR ALL I BONDS

rnings rates and actual yields for I Bonds are shown in the I Bond Earnings Report.

ƆRE INFORMATION

ᶠormation about savings bonds is available at Public Debt's website at www.treasurydirect.gov. Check out our Savings Bond Calculator see how easy it is to find out what your bonds are worth, what they're earning, and even keep track of them. Or, download the free vings Bond Wizard™ to keep track of your savings bond portfolio. An Earnings Report, which contains rate and yield information for nds is available by mail. Send a postcard asking for "Earnings Report" to Bureau of the Public Debt, 200 Third Street, Parkersburg, WV 106-1328.

-647

Intellectual Property | Privacy & Security Notices | Terms & Conditions | Accessibility | Data Quality

U.S. Department of the Treasury, Bureau of the Public Debt

Last Updated September 27, 2004

JS - 1503

Bureau of the Public Debt
United States Department of the Treasury

3UREAU OF THE PUBLIC DEBT ANNOUNCES SERIES EE SAVINGS BOND RATE ꟳOR MAY THROUGH OCTOBER 2004

ꟳOR RELEASE AT 10:00 AM EST

ꟿay 3, 2004

he Bureau of the Public Debt today announced the rate for Series EE savings bonds issued on or after May 1, 1997.

ERIES EE SAVINGS BOND RATE – 2.84%

he 2.84 percent Series EE savings bond rate is in effect for bonds issued on or after May 1, 1997, that enter semiannual earnings eriods from May through October 2004. The rate is 90 percent of the average 5-year Treasury securities yields for the preceding six ıonths. A new interest rate is announced effective each May 1 and November 1. A 3-month interest penalty is applied to these bonds if edeemed before five years. The Series EE bonds on sale now increase in value monthly. The bond's interest rate is compounded emiannually.

avers and investors can now open an on-line account to purchase EE Bonds in electronic form through the website ww.treasurydirect.gov. Account holders can purchase, manage, and redeem such EE Bonds over the Internet 24 hours a day, seven ays a week. These rates also apply to electronic EE Bonds.

ERIES EE BONDS ISSUED BEFORE MAY 1997

eries EE Bonds issued before May 1997 earn various rates for semiannual earnings periods beginning between May 1 and October 1,)04, depending on dates of issue. See the Earnings Report for earnings on Series EE bonds issued from January 1980.

ATURED SERIES E SAVINGS BONDS AND SAVINGS NOTES

eries E savings bonds continue to reach final maturity and stop earning interest. Bonds issued from May 1941 through April 1964 along th those issued from December 1965 through April 1974, have stopped earning interest. All Savings Notes, issued from May 1967 rough October 1970, have stopped earning interest. Series E Bonds with issue dates shown here will reach final maturity in the next six onths.

Bonds Issued	Stop Earning Interest
'ay 1964 through October 1964	May 2004 through October 2004
ay 1974 through October 1974	May 2004 through October 2004

ORE INFORMATION

formation about savings bonds is available at Public Debt's website at www.treasurydirect.gov. Check out our Savings Bond Calculator see how easy it is to find out what your bonds are worth, what they're earning, and even keep track of them. Or, download the free vings Bond Wizard™ to keep track of your savings bond portfolio. The table on the back of this release shows actual yields for Series bonds. An Earnings Report, which contains rate and yield information for bonds is available by mail. Send a postcard asking for arnings Report" to Bureau of the Public Debt, 200 Third Street, Parkersburg, WV 26106-1328.

-648

Intellectual Property | Privacy & Security Notices | Terms & Conditions | Accessibility | Data Quality

U.S. Department of the Treasury, Bureau of the Public Debt

Last Updated September 27, 2004

JS - 1504

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 4, 2004
JS-1505

Media Advisory: Treasury Assistant Secretary for Financial Institutions, Wayne Abernathy To Present Honorary Certificate of Recognition To 1st Educational Savings Branch at Wakefield Memorial High School in Westfield, Massachusetts

Treasury Assistant Secretary for Financial Institutions, Wayne A. Abernathy, will present a certificate of recognition to 1st Educational Savings Branch (1st ESB) for its financial education efforts to high school students. Assistant Secretary Abernathy will lead the presentation of the certificate with remarks about the importance of financial education for students, at Wakefield Memorial High School.

The 1st ESB is a fully operational bank branch of The Savings Bank operated by students attending Wakefield Memorial High School. The Savings Bank established the 1stESB in April of 1981, the first of its kind in the country.

WHO:
Assistant Secretary of Financial Institutions Wayne A. Abernathy
Brian D. McCoubrey, President and CEO, The Savings Bank
Cindy Lyons, Branch Manager and Student Trainer, 1st Educational Savings Branch

WHAT:
Senior Treasury official will present an honorary certificate of recognition to 1st Educational Savings Branch for its efforts in financial education to high school students.

WHEN:
Thursday, May 6, 2004
9:45 a.m. EDT

WHERE:
Wakefield Memorial High School
60 Farm Street
Wakefield, MA 01880

****Media interested in covering this event should call Treasury's Office of Public Affairs at (202) 622-2960**

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 4, 2004
JS-1506

Secretary Snow Welcomes Selection of Rodrigo Rato as Managing Director of the International Monetary Fund

We are very pleased with the IMF Executive Board's decision to approve the nomination of Rodrigo Rato as Managing Director. As a former Finance Minister, he directed substantial economic progress in Spain and has an excellent understanding of the realities of economic policymaking. We expect Rodrigo Rato will be a strong and skillful leader of the IMF and will focus on continuing to strengthen the institution, to the benefit of all its members.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

April 7, 2004
JS-1507

Economic Growth in the Greater Middle East
Under Secretary John B. Taylor Remarks
to the Middle East and North Africa (MENA) Region Conference
on the Challenges of Growth and Globalization
April 7, 2004

It is a pleasure for me to speak at this conference. I thank the IMF's Middle East and Central Asia Department and the IMF Institute for inviting me. I have greatly benefited and enjoyed working with dedicated professionals – like George Abed and Mohsin Khan – at the IMF.

I wish that I could have participated in the whole conference, especially to have been here this morning to listen to the papers by George Abed and others. That this type of economic growth research is having a significant impact on development policy is one of the themes of my remarks today. And it would have been a special pleasure to spend more time interacting with my former Stanford colleague, Guido Tabellini, in a rough-and-tumble seminar setting. But my job now is much more about applying economic research in practice than conducting such research.

Economic growth in the greater Middle East is a high priority of the Bush administration. As President Bush made clear in his National Endowment for Democracy speech on the greater Middle East last November, these economic growth issues are closely linked with political and security issues, perhaps even more so than in any other part of our foreign policy. One indication of the importance of economic issues in this region for the U.S. Treasury is that I have traveled to the Middle East or key neighboring regions a dozen times since I was sworn in as Under Secretary in 2001.

My most recent trip was six weeks ago. I visited Baghdad, Amman, Kabul, Jerusalem, and Ramallah. I learned a tremendous amount – I want to emphasize this. I met with the finance ministers and other government officials in each city. I talked about U.S. assistance packages, about fundraising, and about ways to increase economic growth. I visited reconstruction projects and schools to see how our assistance is being used, and I met with entrepreneurs to listen to their views on economic reform. On this trip, I covered almost exactly the same ground as I did on a trip last June, when I visited the finance ministers and other officials from Iraq, Jordan, Afghanistan, Israel, and the Palestinian Authority. The two trips were separated in time by only eight months, yet, it was striking to me how much had transpired in each of these five places during that period. I would like to highlight these changes to illustrate our approach to economic growth in the Middle East.

Let me first emphasize, as President Bush said in his speech last November, "As we watch and encourage reforms in the region, we are mindful that modernization is not the same as Westernization.... There are, however, essential principles common to every successful society, in every culture."

Many of those common principles are essential for raising economic growth. Again to quote President Bush, successful societies: (1) "protect freedom and the consistent, impartial rule of law;" (2) "invest in the health and education of their people;" and (3) "privatize their economies and secure the rights of property." These essential principles closely parallel the principles that underlie the new Millennium Challenge Account, which is an important new initiative in U.S. foreign aid. In that context, we speak of policies of "governing justly, investing in people, and encouraging economic freedom" as essential for economic growth.

But how do we know that these principles are essential? First of all, it is clear that the lack of high productivity jobs is the source of poverty and low incomes in the world, including the poorer areas of the Middle East and North Africa. If there are only low productivity jobs - or no jobs - then incomes will be low and there will be more poverty. It is almost a tautology.

Unfortunately, the recent trends in productivity growth in the Middle East are not good. Guido Tabellini, in his paper for this conference, notes that productivity actually *fell* in the Middle East in the last 20 years, by 0.7 percent per year. In contrast, this is a period when productivity was increasing in the United States, Europe and East Asia. This contrast is particularly strong and, I think, worrisome. And the pressure on increasing productivity and creating jobs will not diminish in the years ahead in the Middle East. Projections are that the working age population in the Middle East and North Africa will increase by about 50 million in the next ten years.

Why are so few high productivity jobs being created? According to basic economic growth theory, productivity depends on two things: the amount of capital each person has to work with and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries or areas that are behind in productivity should have a higher productivity growth rate. Capital will flow to where it is in short supply relative to labor and, with more capital, higher productivity jobs can be created. Similarly, technology can spread through education and training. For these reasons, poor areas or countries can and should be catching up to rich areas or countries.

There is evidence for such catch-up when there are few impediments to the use and accumulation of capital and technology. It is unfortunate that there is little evidence of such catch-up in the last twenty years in the greater Middle East as a whole. Why has there not been more catch-up? More and more evidence has been accumulating that significant impediments to investment and the adoption of technology are holding back countries and people.

One can group these impediments into three areas. It is not a coincidence that these three areas correspond to the principles I listed from President Bush's recent speech on the greater Middle East, or principles from the Millennium Challenge Account.

First, poor governance – for example, the lack of the rule of law – creates disincentives to invest, to start up new firms, and to expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. In developing the Millennium Challenge Account, we used several indicators to measure the rule of law – some developed by the World Bank Institute and some by other organizations; all are publicly available. The measures of the rule of law for MENA have a rating which is relatively low. For example, it is about one-fourth that of Canada: the numbers are 0.52 for the Middle East region and 2.11 for Canada, which in this context is representative of Europe, U.S., Japan and other industrialized nations. Of course, there is diversity within the greater Middle East area. The UAE measure, for instance, is much closer to Canada's number than to the Middle East average.

Second, poor education and health impede the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to adopt new technologies which increase the productivity of the jobs that they have already.

What do we know here? It depends on how much students are learning. As a former professor, I know that sometimes you don't know how effective you are until 20 years later. But the measures we have now, for example, on primary education completion rates show that the average for MENA is a 75 percent completion rate. In industrialized countries, the completion rate is much higher. So, again there is a difference in education which could explain some of the differences in productivity which I discussed earlier.

The third impediment to growth relates to economic freedom. Too many restrictions on economic transactions prevent people from trading goods and services and from adopting new technologies. Lack of openness to trade, state monopolies, and excessive regulation are all examples of restrictions that reduce the incentives for innovation and investment needed to boost productivity.

What do we know about this? Again, there are indicators that we have tried to use in practice. One indicator of which I am particularly fond is the length of time it takes to start a business. The literature shows that this is a predictor of growth. In the MENA area, the average number of days that it takes to start a business is 43. In Canada, the average is three days, while in some countries in the MENA, it's much longer than 43 days.

Trade openness is another indicator that has been measured by many objective institutions. Here, a higher number in the index means less openness. For MENA, the number is 4.0, while it's 2.0 for both Canada and Australia. Of course, other economic indicators show less difference with industrialized countries. Inflation, for example, is one of the indices on which the MENA region performs very well.

As a policy maker, I ask: How do we translate these very good ideas, research and measures of performance into what we do everyday? People like us ask these questions and remain convinced that improvement in the policies of ruling justly, investing in people, and encouraging economic freedom is what is needed to increase economic growth in the Middle East. I'd like to share with you several examples of what is actually happening on the ground, based on my recent visits to the Middle East region.

First, when I speak with finance ministers, central bank governors, and private business people in the greater Middle East countries, I find no disagreement with this way of thinking about economic growth. They tell me what I've said here today. Indeed, I usually hear these same ideas even before I begin talking. It's no secret that in order to raise economic growth, one has to focus on these measures.

Second, it is clear that cases within the Middle East where good progress has been and is being made. There are many examples of market-oriented economies that are removing barriers to economic growth. To name a few:

- Bahrain is a leading financial and trading center.
- Dubai has transformed itself into an important regional economic center.
- Morocco, as part of its free trade agreement with the United States, committed to keep its financial sector open to foreign investment. It also agreed to make its procedures for new regulation more transparent by allowing interested parties the opportunity to comment on proposed regulations.

Next, I'd like to share with you a few snapshots of my recent trips that illustrate how much has improved in the last eight months:

In Afghanistan, in the last few months, a new currency has been issued, roads has been completed and a new banking law has been passed which should assist in attracting foreign capital. Now, many more boys and girls are in school; industrial parks are being built; and customs facilities are being improved. Much work is also being done on land titling to establish property rights.

In Iraq, within only a few months, a new currency was introduced, and a seminal law was passed to make the central bank independent. Recently, I met with a group of private bankers in Baghdad who were forming a trade group. Foreign bank entry is progressing, with three foreign banks being considered for banking licenses, including the National Bank of Kuwait.

I also recently traveled to Jordan, where the government recently passed a new budget that will reduce subsidies that have been making it difficult for the economy to adjust. Jordan has used qualified industrial zones to increase trade with great results. Exports in Jordan grew by over 20 percent in 2001 and 2002.

For the Palestinian Authority, Finance Minister Fayyad has made remarkable progress toward a good, transparent budget process, including a direct deposit system under which funds are disbursed directly to employees. He has also helped to bring the petroleum monopoly under the control of the Finance Ministry. The business community similarly recognizes that better regulation, better infrastructure and, of course, peace in that region would make a considerable difference in economic growth.

In Israel, Finance Minister Netanyahu has put through a number of laudable reforms, including tax reductions and welfare and pension system reforms. Israel is poised to continue on this path with further privatization, improvements in the regulatory process, and increasing competition in the financial sector.

These are some of the very encouraging, significant measures that have taken place in a period of eight months in the greater Middle East region. I wish to leave you with a few examples of how we can continue to interact and engage one another constructively on these issues.

- Secretary Snow had a very important meeting with the Finance Ministers from the region in Dubai last September to begin a dialogue about how we can best work together on financial sector issues. The United States is also establishing a Partnership for Financial Excellence, which is an effort to provide technical assistance and training in the region.

- In 2002, Treasury held a very successful workshop entitled “Islamic Finance 101” to educate U.S. policymakers about developments in Islamic finance.

- I was very impressed to learn about a recent European Central Bank meeting with the governors of the central banks from the MENA region.

- Finally, I am very pleased that the IMF has proposed establishing a training center in the region.

I look forward to continued progress on these and other important initiatives to promote economic growth in the MENA region. And I thank you again for giving me the opportunity to speak here today.

RESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 5, 2004
2004-5-5-15-1-6-19739

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 $82,199 million as of the end of that week, compared to $82,944 million as of the end of the prior week.

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

		April 23, 2004			April 30, 2004	
TOTAL		**82,944**			**82,199**	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	9,070	14,380	23,450	9,204	14,252	23,456
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,898	2,889	14,787	12,068	2,864	14,932
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			21,219			20,322
3. Special Drawing Rights (SDRs) [2]			12,443			12,445
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

		April 23, 2004			April 30, 2004	
	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

	April 23, 2004			April 30, 2004		
	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 IMF data for the prior month end.

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 5, 2004
JS-1508

MEDIA ADVISORY
Treasury Secretary Snow To Visit Wisconsin and Illinois This Week

Treasury Secretary John W. Snow will travel to Racine, Wisconsin and Chicago, Illinois May 6-7 to meet with local business leaders, announce recipients of Treasury's New Markets Tax Credit awards, and to give a speech on the President's efforts to strengthen the economy.

As a result of President Bush's tax reform legislation in 2001 and 2003, more than 2.1 million taxpayers in Wisconsin and more than 4.6 million taxpayers in Illinois will have lower income tax bills in 2004.

The New Market Tax Credit (NMTC) program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most.

Established by Congress in December 2000, the NMTC program stimulates investment and creates jobs in our nation's low income communities. It permits individual and corporate taxpayers to receive a credit against Federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). Substantially, all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The credit provided to the investor totals 39 percent of the face value of the investment and is claimed over a seven-year credit allowance period.

The following events are open to the media:

Thursday, May 6

New Market Tax Credit press conference
1:30 pm CDT
The Johnson Building
555 Main Street
Racine, WI
** **Media must arrive by 12:45 pm and must wear their official media credentials**

Friday, May 7

Remarks to Federal Reserve Bank of Chicago
8:30 am CDT
Fairmont Hotel
200 North Columbus Drive
Chicago, IL
** **Media must arrive by 7:45 am and must wear their official media credentials**

New Market Tax Credit press conference
11:30 am CDT

The Pablo Friere Child Care Center
1653 West 43rd Street
Chicago, IL

**** Media must arrive by 10:00 am and must wear their official media credentials**

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 5, 2004
js-1509

Treasury Secretary Snow Statement on House Passage to Extend Alternative Minimum Tax Relief

The expected growth in the individual alternative minimum tax (AMT) is a major problem in the tax code that must be addressed. I applaud the House of Representatives for acting to extend the temporary AMT relief for millions of middle class families. These temporary provisions will keep the number of taxpayers affected by the AMT from rising significantly in the near-term. More importantly, this temporary extension will allow the Treasury Department the time necessary to develop a comprehensive set of proposals to deal with the AMT in the long-term.

H.R. 4227 extends through 2005 temporary Alternative Minimum Tax (AMT) relief. Specifically, H.R. 4227 would maintain the current AMT exemption amount indexed for inflation through 2005.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 5, 2004
JS-1510

Treasury Issues Proposed Regulations Regarding Tax-Exempt Bonds for Solid Waste Disposal Facilities

Today the Treasury Department and the Internal Revenue Service issued proposed regulations relating to tax-exempt private activity bonds issued to finance solid waste disposal facilities.

"These proposed regulations update the existing regulations and provide certainty to issuers and holders of tax-exempt bonds for solid waste disposal facilities," stated Acting Treasury Assistant Secretary for Tax Policy Greg Jenner.

In 2002, the Treasury Department and the IRS requested public comments on the application of the rules for solid waste disposal facility bonds to recycling facilities. In response to comments received, the proposed regulations take into account changes in the waste recycling industry that have occurred since the existing regulations were issued in 1972.

The existing regulations provide that a facility will not qualify as a solid waste disposal facility if the material processed at the facility has any market or other value. As a result of changes in the waste recycling industry, the proposed regulations do not include this requirement. The proposed regulations provide guidance on the types of material that constitute solid waste and the types of activities that are permitted uses of a solid waste disposal facility, which include final disposal, conversion, recovery, and transformation processes as well as preliminary functions and functionally related and subordinate activities.

-30-

REPORTS

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-140492-02]

RIN 1545-BD04

Definition of Solid Waste Disposal Facilities for Tax-exempt Bond Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations on the definition of solid waste disposal facilities for purposes of the rules applicable to tax-exempt bonds issued by State and local governments. These regulations provide guidance to State and local governments that issue tax-exempt bonds to finance solid waste disposal facilities and to taxpayers that use those facilities. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Outlines of topics to be discussed at the public hearing scheduled for August 11, 2004, at 10 a.m., must be received by August 4, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-140492-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-140492-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically to the IRS Internet site at www.irs.gov/regs, or via the Federal eRulemaking Portal at www.regulations.gov (IRS - REG-140492-02). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Michael P. Brewer, (202) 622-3980; concerning submissions and the hearing, Sonya Cruse, (202) 622-4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Generally, interest on a State or local bond is excluded from gross income under section 103 of the Internal Revenue Code (Code). However, section 103(b) provides that the exclusion does not apply to a private activity bond unless the bond is a qualified bond. Section 141(e) defines qualified bond to include an exempt facility bond that meets certain requirements. Section 142(a) lists the categories of exempt facility bonds, which include bonds for solid waste disposal facilities under section

142(a)(6).

Section 1.103-8(f)(2)(ii)(*a*) of the Income Tax Regulations generally defines *solid waste disposal facilities* as any property or portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. Section 1.103-8(f)(2)(ii)(*b*) provides that the term *solid waste* has the same meaning as in former section 203(4) of the Solid Waste Disposal Act (42 U.S.C. 3252(4)), as quoted in §1.103-8(f)(2)(ii)(*b*), except that material will not qualify as solid waste unless, on the date of issue of the obligations issued to provide the facility to dispose of the waste material, it is property that is useless, unused, unwanted, or discarded solid material that has no market or other value at the place where the property is located (the *no-value test*). Thus, under the existing regulations, when any person is willing to purchase the property, at any price, the material is not waste. However, if any person is willing to remove the property at his own expense but is not willing to purchase it at any price, the material is waste under the existing regulations.

Former section 203(4) of the Solid Waste Disposal Act, as quoted in §1.103-8(f)(2)(ii)(*b*), provides that the term *solid waste* means,

> garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial, and agricultural operations,

> and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants.

Section 1.103-8(f)(2)(ii)(c) states that a facility that disposes of solid waste by reconstituting, converting, or otherwise recycling it into material that is not waste also qualifies as a solid waste disposal facility if solid waste constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process. Such a recycling facility does not fail to qualify as a solid waste disposal facility under the existing regulations solely because it operates at a profit.

Section 17.1(a) of the temporary Income Tax Regulations generally provides that, in the case of property that has both a solid waste disposal function and a function other than the disposal of solid waste, only the portion of the cost of the property allocable to the function of solid waste disposal is taken into account as an expenditure to provide solid waste disposal facilities. However, under §17.1(a), a facility that otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than solid waste disposal merely because material or heat that has utility or value is recovered or results from the disposal process. Section 17.1(a) provides that, when materials or heat are recovered, the waste disposal function includes the processing of those materials or heat that occurs in order to put them into the form in which the materials or heat are in fact sold or used, but does not include further processing that converts the materials or heat into other products.

Section 17.1(b) provides that the portion of the cost of property allocable to solid waste disposal is determined by allocating the cost of the property between the property's solid waste disposal function and any other functions by any method which, with reference to all the facts and circumstances with respect to the property, reasonably reflects a separation of costs for each function of the property.

In Notice 2002-51 (2002-2 C.B. 131) the IRS and Treasury Department requested public comments on the application of section 142(a)(6) to recycling facilities. Notice 2002-51 also invited comments on any other issues concerning the application of that Code provision.

In response to the Notice, commentators suggested that the rules governing exempt facility bonds for solid waste disposal facilities should be consistent with national policies to encourage, facilitate, and increase recycling. For example, commentators stated that the rules should not deny tax-exempt financing to recycling while providing such financing to landfills and municipal waste incinerators.

Commentators suggested revisions to the no-value test used for determining whether material is solid waste. For example, commentators suggested that material that has a market or other value at the place it is located only by reason of its value for recycling should not be considered to have a market or other value. Commentators also suggested that material acquired by a recycler should qualify as solid waste if the amounts paid to the packer, collector or similar party are not in excess of the cost of transporting and handling the material. Some commentators suggested that the determination of whether material is waste should be made at the point of generation prior to the time costs are incurred to divert the material from the waste stream.

Commentators also suggested that the determination of when the waste recycling process stops should not depend on whether the activity is being carried out by a single party or multiple parties, or whether there has been a change of ownership of the material.

The IRS and Treasury Department have considered these comments, and the proposed regulations contained in this document (the proposed regulations) implement a number of these recommendations.

Explanation of Provisions

I. Solid Waste

The proposed regulations contain proposed amendments to 26 CFR part 1 regarding exempt facility bonds for solid waste disposal facilities. In light of the changes that have occurred in the waste recycling industry since the existing regulations were issued in 1972, the proposed regulations eliminate the no-value test for determining whether material is solid waste. The proposed regulations retain the definition of solid waste under former section 203(4) of the Solid Waste Disposal Act, quoted above, and provide guidance for determining whether material constitutes "garbage, refuse and other discarded solid materials" under that definition.

Thus, the proposed regulations provide that the term solid waste means garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants.

For these purposes, the proposed regulations provide that garbage, refuse and other discarded solid materials means material that is solid and that is introduced into a final disposal process, conversion process, recovery process, or transformation process (as those terms are defined in the proposed regulations and described in part II below) unless the material falls within one of several categories of excluded items.

The first category of material that does not constitute solid waste is material that is introduced into a conversion process if the material is either: (1) a fossil fuel; or (2) any material that is grown, harvested, produced, mined, or otherwise created for the principal purpose of converting the material to heat, hot water, steam, or another useful form of energy. For this purpose, material is not treated as grown, harvested, produced, mined, or otherwise created for the principal purpose of converting the material to heat, hot water, steam, or another useful form of energy just because an operation is performed on the material to make the material more conducive to being converted to heat, hot water, or steam. For example, if material that is not otherwise grown, harvested, produced, mined, or created for the principal purpose of converting the material to a useful form of energy is formed into pellets to make the material more conducive to being incinerated to produce steam, the creation of pellets does not cause the material to be produced or created for the principal purpose of converting the material to steam.

The second category of material that does not constitute solid waste is any precious metal that is introduced into a recovery process.

The regulations are reserved with respect to any additional category of excluded material that may be specified with respect to a transformation process.

Under the proposed regulations, hazardous material is not solid waste if the material is disposed of at a facility that is subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on October 22, 1986, the date of the enactment of the Tax Reform Act of 1986). Thus, under the proposed regulations, a hazardous waste disposal facility described in section 142(h)(1) would not qualify as a solid waste disposal facility.

Finally, the proposed regulations provide that radioactive material is not solid waste.

II. Solid Waste Disposal Facility

A. In General

The proposed regulations provide that a facility is a solid waste disposal facility to the extent that the facility is: (1) used to perform a solid waste disposal function (as defined in the proposed regulations and discussed in part II, B below); (2) used to perform a preliminary function (as defined in the proposed regulations and discussed in part II, C below); or (3) functionally related and subordinate (within the meaning of

§1.103-8(a)(3)) to a facility that is used to perform a solid waste disposal function or a preliminary function.

B. Solid Waste Disposal Function

The proposed regulations define solid waste disposal function as the processing of solid waste in (1) a final disposal process, (2) a conversion process, (3) a recovery process, or (4) a transformation process.

1. Final Disposal Process

Under the proposed regulations, a final disposal process is (1) the placement of material in a landfill or (2) the incineration of material without any useful energy being captured. Comments are requested on whether other types of processes should be included in the definition of final disposal process.

2. Conversion Process

The proposed regulations define conversion process as a process in which material is incinerated and heat, hot water, or steam is created and captured as useful energy. For this purpose, the conversion process begins with the incineration of material and ends at the point at which the latest of heat, hot water, or steam is created. Thus, the conversion process ends before any transfer or distribution of heat, hot water or steam. Comments are requested on the definition of conversion process in the proposed regulations, including whether the definition should include processes in which useful energy in a form other than heat, hot water, or steam is created.

3. Recovery Process

The proposed regulations define recovery process as a process that starts with the melting or re-pulping of material to return the material to a form in which the material previously existed for use in the fabrication of an end product and ends immediately before the material is processed in the same or substantially the same way that virgin material is processed to fabricate the end product.

The proposed regulations further provide that, if an end product is fabricated entirely from non-virgin material, the recovery process ends immediately before the non-virgin material is processed in the same or substantially the same way that virgin material is processed in a comparable fabrication process that uses only virgin material or a combination of virgin and non-virgin material.

The proposed regulations also specify that refurbishing, repair, or similar activities are not recovery processes.

Comments are requested on the definition of recovery process in the proposed regulations, including whether the definition should include processes, other than melting or re-pulping, that return material to a form in which the material previously existed.

4. Transformation Process

The IRS and Treasury Department recognize that certain processes in which material is transformed for use in the creation of a useful product (transformation processes) should be treated as solid waste disposal functions. A transformation process could include, for example, shredding used tires for use as roadbed material. However, defining a transformation process requires clear criteria that distinguish a transformation process from a manufacturing or production process that uses material other than solid waste. The proposed regulations reserve on the definition of transformation process so that the public may comment on how the definition should be crafted to meet this objective within the context of the proposed regulations. Comments are requested in particular on whether the definition of a transformation process should be limited to the processing of particular types of materials to produce certain categories of products, and, if so, what types of materials and which categories of products should be included.

C. Preliminary Function

A facility is a solid waste disposal facility under the proposed regulations to the extent that the facility is used to perform a preliminary function. For this purpose, a preliminary function is the collection, separation, sorting, storage, treatment, processing, disassembly, or handling of solid material that is preliminary and directly related to a solid waste disposal function. However, no portion of a collection, separation, sorting, storage, treatment, processing, disassembly, or handling activity is a preliminary function unless, for each year while the issue is outstanding, more than 50 percent, by weight or volume, of the total materials that result from the entire activity (both the part that is preliminary and directly related to a solid waste disposal function and the part that is not preliminary and directly related to a solid waste disposal function) is solid waste. For example, if a facility sorts material and some of the sorted material is processed in a solid waste disposal function and some of the sorted material is processed in another manner, a portion of the sorting facility is a solid waste disposal facility if, for each year while the issue is outstanding, more than 50 percent, by weight or volume, of all the sorted material is solid waste.

D. Mixed-Function Facilities

The proposed regulations provide that, in general, if a facility is used to perform both (1) a solid waste disposal function or a preliminary function, and (2) another function, then the costs of the facility allocable to the solid waste disposal function or the preliminary function are determined using any reasonable method, based on all the facts and circumstances. This rule applies, for example, if a facility is used (1) to process solid waste in a recovery process and (2) to perform another function that is neither a solid waste disposal function (because it does not process solid waste in a final disposal process, conversion process, recovery process, or transformation process) nor a preliminary function (because it is not preliminary and directly related to a solid waste disposal function).

The proposed regulations also contain a special rule to determine the portion of the costs of property that are allocable to a solid waste disposal function if the property is used to perform a final disposal process, conversion process, recovery process, or transformation process and the inputs to the process consist of solid waste and material that is not solid waste. Under this special rule, the portion of the costs of property used to perform such a process that are allocable to a solid waste disposal function equals the lowest percentage of solid waste processed in the process in any year while the issue is outstanding. The percentage of solid waste processed in such a process for any year is the percentage, by weight or volume, of the total materials processed in the process that constitute solid waste for that year. If, however, for each year while the issue is outstanding, solid waste constitutes at least 80 percent, by weight or volume, of the total materials processed in the process, all of the costs of the property used to perform the process are allocable to a solid waste disposal function.

Proposed Effective Date

The proposed regulations will apply to bonds that are: (1) sold on or after the date that is 60 days after the date of publication of final regulations under section 142(a)(6) in the **Federal Register**; and (2) subject to section 142. However, the proposed regulations provide that an issuer is not required to apply the regulations to bonds described in the preceding sentence that are issued to refund a bond to which the regulations do not apply if the weighted average maturity of the refunding bonds is not longer than the weighted average maturity of the refunded bonds. Section 1.103-8(f)(2) of the Income Tax Regulations and §17.1 of the temporary Income Tax Regulations will not apply to bonds that are subject to the final regulations under section 142(a)(6).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory

Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the 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 (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules 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 August 11, 2004, at 10 a.m. in the auditorium, 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 lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**] and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by August 4, 2004.

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.

Comments are requested on all aspects of the proposed regulations, including those aspects for which specific requests for comments are set forth above.

Drafting Information

The principal authors of these regulations are Michael P. Brewer, Timothy L. Jones and Rebecca L. Harrigal, Office of Chief Counsel, IRS (TE/GE). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 1.142(a)(6)-1 is added to read as follows:

§1.142(a)(6)-1 Exempt facility bonds: solid waste disposal facilities.

(a) *In general*. Section 103(a) provides that, generally, interest on a state or local bond is not included in gross income. However, this exclusion does not apply to any private activity bond that is not a qualified bond. Section 141(e) defines *qualified bond* to include an exempt facility bond that meets certain requirements. Section 142(a) defines *exempt facility bond* as any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide a facility specified in section 142(a). One type of facility specified in section 142(a) is a solid waste disposal facility. This section defines the term solid waste disposal facility for purposes of section 142(a).

(b) *Solid waste disposal facility*--(1) *In general*. The term *solid waste disposal facility* means a facility to the extent that the facility is--

(i) Used to perform a solid waste disposal function (within the meaning of paragraph (b)(2) of this section);

(ii) Used to perform a preliminary function (within the meaning of paragraph (b)(3) of this section); or

(iii) Functionally related and subordinate (within the meaning of §1.103-8(a)(3)) to a facility that is used to perform a solid waste disposal function or a preliminary function.

(2) Solid waste disposal function. A solid waste disposal function is the processing of solid waste (as defined in paragraph (c) of this section) in--

(i) A final disposal process (as defined in paragraph (d) of this section);

(ii) A conversion process (as defined in paragraph (e) of this section);

(iii) A recovery process (as defined in paragraph (f) of this section); or

(iv) A transformation process (as defined in paragraph (g) of this section).

(3) Preliminary function. A preliminary function is the collection, separation, sorting, storage, treatment, processing, disassembly, or handling of solid material that is preliminary and directly related to a solid waste disposal function. However, no portion of a collection, separation, sorting, storage, treatment, processing, disassembly, or handling activity is a preliminary function unless, for each year while the issue

is outstanding, more than 50 percent, by weight or volume, of the total materials that result from the entire activity is solid waste.

(4) Mixed-function facilities. Paragraph (h) of this section provides rules for determining the portion of a facility that is a solid waste disposal facility for a facility that is used to perform--

(i) A solid waste disposal function or a preliminary function; and

(ii) Another function.

(c) Solid Waste--(1) In general. For purposes of this section, the term solid waste means garbage, refuse, and other discarded solid materials (as defined in paragraph (c)(2) of this section), including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants. Liquid or gaseous waste is not solid waste.

(2) Garbage, refuse and other discarded solid materials--(i) In general. For purposes of paragraph (c)(1) of this section, garbage, refuse and other discarded solid materials means

material that is solid and that is introduced into a final disposal process, conversion process, recovery process, or transformation process unless the material is described in paragraph (c)(2)(ii), (iii), (iv), (v) or (vi) of this section.

(ii) Certain material introduced into a conversion process. Material is described in this paragraph (c)(2)(ii) if the material is introduced into a conversion process and the material is--

(A) A fossil fuel; or

(B) Any material that is grown, harvested, produced, mined, or otherwise created for the principal purpose of converting the material to heat, hot water, steam, or another useful form of energy. For example, organic material that is closed-loop biomass under section 45(c) is described in this paragraph (c)(2)(ii) if the material is introduced into a conversion process. Material is not treated as described in this paragraph (c)(2)(ii) just because an operation is performed on the material to make the material more conducive to being converted to heat, hot water, or steam. For example, if material that is not otherwise grown, harvested, produced, mined, or created for the principal purpose of converting the material to a useful form of energy is formed into pellets to make the material more conducive to being incinerated to produce steam, the creation of pellets does not cause the material to be produced or created for the principal purpose of converting the material to steam.

(iii) *Certain material introduced into a recovery process*. Material is described in this paragraph (c)(2)(iii) if the material is introduced into a recovery process, and the material is a precious metal.

(iv) *Certain material introduced into a transformation process*. [Reserved].

(v) *Certain hazardous material*. Material is described in this paragraph (c)(2)(v) if the material is hazardous material and it is disposed of at a facility that is subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on October 22, 1986, the date of the enactment of the Tax Reform Act of 1986). See section 142(h)(1).

(vi) *Radioactive material*. Material is described in this paragraph (c)(2)(vi) if the material is radioactive.

(d) *Final disposal process*. The term *final disposal process* means--

(1) The placement of material in a landfill; or

(2) The incineration of material without any useful energy being captured.

(e) *Conversion process*. The term *conversion process* means a process in which material is incinerated and heat, hot water, or steam is created and captured as useful energy. The conversion process begins with the incineration of material and ends at the point at which the latest of heat, hot water, or steam is created. Thus, the conversion process ends before any transfer or distribution of heat, hot water or steam.

(f) Recovery process--(1) In general. The term recovery process means a process that starts with the melting or re-pulping of material to return the material to a form in which the material previously existed for use in the fabrication of an end product and ends immediately before the material is processed in the same or substantially the same way that virgin material is processed to fabricate the end product. For example, melting non-virgin metal to fabricate a metal product is not a recovery process if virgin metal is melted in the same or substantially the same process to fabricate the product.

(2) End products fabricated entirely from non-virgin material. If an end product is fabricated entirely from non-virgin material, the recovery process ends immediately before the non-virgin material is processed in the same or substantially the same way that virgin material is processed in a comparable fabrication process that uses only virgin material or a combination of virgin and non-virgin material. For example, if new paper is fabricated entirely from re-pulped, non-virgin material, the recovery process ends immediately before the non-virgin material is processed in the same or substantially the

same manner that virgin material is processed in the fabrication of paper made only with virgin material, or with a mixture of virgin and non-virgin material.

(3) Refurbishing, repair, or similar activities. Refurbishing, repair, or similar activities are not recovery processes.

(g) Transformation process. [Reserved].

(h) Mixed-function facilities--(1) In general. Except to the extent provided in paragraph (h)(2) of this section, if a facility is used to perform both a solid waste disposal function or a preliminary function and another function, then the costs of the facility allocable to the solid waste disposal function or the preliminary function are determined using any reasonable method, based on all the facts and circumstances. See §1.103-8(a)(1) for rules relating to which amounts are used to provide an exempt facility.

(2) Mixed inputs--(i) In general. Except as provided in paragraph (h)(2)(ii) of this section, for each final disposal process, conversion process, recovery process, or transformation process, the percentage of costs of the property used to perform such process that are allocable to a solid waste disposal function equals the lowest percentage of solid waste processed in that process in any year while the issue is outstanding. The percentage of solid waste processed in such process for any year

is the percentage, by weight or volume, of the total materials processed in that process that constitute solid waste for that year.

(ii) Special rule for mixed-input processes if at least 80 percent of the materials processed are solid waste. For each final disposal process, conversion process, recovery process, or transformation process, all of the costs of the property used to perform such process are allocable to a solid waste disposal function if, for each year while the issue is outstanding, solid waste constitutes at least 80 percent, by weight or volume, of the total materials processed in the process.

(i) Examples. The following examples illustrate the application of this section:

Example 1. Final disposal process. Garbage trucks collect solid material at curbside from businesses and residences and dump the material in a landfill owned by Company A. The landfill is not subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on the date of the enactment of the Tax Reform Act of 1986). The placement of material in the landfill is a final disposal process. The solid material placed in the landfill is solid waste under paragraph (c) of this section. Therefore, the landfill is a solid waste disposal facility.

Example 2. Recovery process. Company B re-pulps magazines and cleans the pulp. After cleaning, B mixes the pulp with virgin material and uses the mixed material to produce rolls of paper towels. Before the mixing, the re-pulped material is not processed in the same or substantially the same way that virgin material is processed to produce the paper towels. The process starting with the re-pulping of the magazines and ending immediately before the re-pulped material is mixed with the virgin material is a recovery process. The magazines introduced into the recovery process are solid waste. Therefore, the property that re-pulps the magazines and the property that cleans the re-pulped material are used to perform a solid waste disposal function.

Example 3. Preliminary function. Company C owns a paper mill. At the mill, logs from nearby timber operations are processed through a machine that removes bark. The stripped logs are used to manufacture paper. The stripped bark falls onto a conveyor belt that transports the bark to a storage bin used to briefly store the bark until C feeds the bark into a boiler. The conveyor belt and storage bin are used only for these purposes. The boiler is used only to create steam by burning the bark, and the steam is used to generate electricity. The creation of steam from the stripped bark is a conversion process that starts with the incineration of the stripped bark. The conversion process is a solid waste disposal function. The conveyor belt performs a collection activity that is preliminary and that is directly related to the solid waste disposal function. The storage bin performs a storage function that is preliminary and that is directly related to the solid waste disposal function. Thus, the conveyor belt and storage bin are solid waste disposal facilities. The removal of the bark does not have a sufficient nexus to the conversion process to be directly related to the conversion process; the process of removing the bark does not become directly related to the conversion process merely because it results in material that will be waste used in the conversion process.

Example 4. Mixed-input facility. Company D owns an incinerator financed by an issue and uses the incinerator exclusively to burn coal (a fossil fuel) and other solid material to create steam that is used to generate electricity. Each year while the issue is outstanding, 30 percent by volume and 40 percent by weight of the solid material that D processes in the conversion process is a fossil fuel. The remainder of the solid material processed is neither a fossil fuel nor material that was grown, harvested, produced, mined, or otherwise created for the principal purpose of converting the material to heat, hot water, steam, or another useful form of energy. Seventy percent of the costs of the property used to perform the conversion process are allocable to a solid waste disposal function.

Example 5. Mixed-function facility. Company E owns and operates a facility financed by an issue and uses the facility exclusively to sort damaged bottles from bottles that may be re-filled. The damaged bottles are directly introduced into a process that melts them for use in the fabrication of an end product. The melting process is a recovery process. Each year while the issue is outstanding, more than 50 percent, by weight or volume, of all of the bottles that pass out of the sorting process are damaged bottles that are processed in a recovery process. The sorting facility performs a preliminary function, but it also performs another function. The costs of the sorting facility allocable to the preliminary function are determined using any reasonable method, based on all the facts and circumstances.

(j) Effective date--(1) In general. Except as provided in paragraph (j)(2) of this section, this section applies to bonds that are--

(i) Sold on or after the date that is 60 days after the date of publication of final regulations in the **Federal Register**; and

(ii) Subject to section 142.

(2) Certain refunding bonds. An issuer is not required to apply this section to bonds described in paragraph (j)(1) of this section that are issued to refund a bond to which this section does not apply if the weighted average maturity of the refunding

bonds is not longer than the weighted average maturity of the refunded bonds.

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
js-1511

Under Secretary Taylor to travel to China, Japan, Korea for economic, development meetings

John Taylor, U.S. Treasury Under Secretary for International Affairs, will travel to China, Japan and Korea May 10-16, with attention to current global and regional economic issues.

In Beijing, China, Taylor will be joined by Ambassador Paul Speltz, recently named by Secretary John Snow as his personal emissary to China on economic and financial relations between the nations. On May 10-11, Taylor and Speltz will meet with senior officials of the government of China's economic team to discuss the Chinese economy, progress on financial liberalization, the state of the banking system, and issues related to China's currency. They will also meet with economists, financial analysts and members of the business community.

Taylor will be in Japan on May 12-14 where he will meet with officials from Japan's Ministry of Finance and the Bank of Japan to discuss the improving outlook for the Japanese economy. Taylor will also be interested in the continued attention to Japan's efforts to end deflation and to resolve non-performing loans in the Japanese banking system. Taylor will also meet with economic analysts in Tokyo.

On May 14 Taylor will travel to Jeju, Korea to participate in the annual meetings of the Asian Development Bank (ADB). Taylor will focus on the ADB's efforts to raise living standards in the region, including the progress of their reconstruction efforts in Afghanistan. In addition to the ADB meetings, Taylor will hold a number of bilateral discussions with countries from the region. Taylor will depart Korea to return to Washington, DC on May 16.

####

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1512

Treasury Issues Final Regulations On Student Loan Interest Deduction

The Treasury Department and the Internal Revenue Service today issued final regulations relating to the deduction for interest paid on qualified education loans.

"The final regulations issued today clarify which amounts qualify for the student loan interest deduction to ensure that students obtain the maximum deduction permitted under the law," said Acting Assistant Secretary for Tax Policy Greg Jenner. "These regulations also provide guidance to help lenders meet their reporting obligations."

The student loan interest deduction was enacted in 1997 and expanded in 2001, when Congress eliminated the 60-month limit on the time during which interest payments are deductible. These final regulations provide guidance on the treatment of amounts such as capitalized interest and loan origination fees, the deductibility of interest payments made by persons other than the taxpayer, the definition of "qualified education loan," and other issues.

Related regulations on information reporting by institutions that receive payments of interest on qualified education rules were finalized in 2002. Those regulations provided a transition rule for reporting loan origination fees and capitalized interest. In response to comments, the student loan interest regulations issued today provide additional time for institutions to begin reporting payments of capitalized interest and loan origination fees by extending the transition rule for eight months. Institutions will be required to begin reporting those amounts with respect to qualified education loans made on or after September 1, 2004.

- 30

REPORTS

- TD 9125

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9125]

RIN 1545-AW01

Deduction for Interest on Qualified Education Loans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the deduction under section 221 of the Internal Revenue Code (Code) for interest paid on qualified education loans. The final regulations reflect the enactment and amendment of section 221 by the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, and the Economic Growth and Tax Relief Reconciliation Act of 2001. This document also contains amendments to the final regulations under section 6050S relating to the information reporting requirements for interest payments received on qualified education loans. The final regulations affect taxpayers who pay interest on qualified education loans and payees who receive payments of interest on qualified education loans.

DATES: Effective Date: These final regulations are effective May 7, 2004.

Applicability Dates: Section 1.221-1 is applicable to periods governed by section

221 as amended in 2001, which relates to interest paid on qualified education loans after December 31, 2001, and on or before December 31, 2010. Section 1.221-2 is applicable to interest due and paid on qualified education loans after January 21, 1999, but before January 1, 2002, and again after December 31, 2010. Taxpayers also may apply §1.221-2 to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. The amendments to §1.6050S-3 provide a transitional rule for certain interest payments with respect to qualified education loans made before September 1, 2004, and provide guidance applicable to qualified education loans made on or after that date.

FOR FURTHER INFORMATION CONTACT: Sean M. Dwyer at (202) 622-5020 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 21, 1999, the IRS published a notice of proposed rulemaking (REG-116826-97) in the **Federal Register** (64 FR 3257) under section 221 of the Code. The notice of proposed rulemaking implemented section 202 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 778), which added section 221 to the Code. The IRS received written, including electronic, comments responding to the proposed regulations. There were no requests for a public hearing and none was held.

Subsequent to the publication of the proposed regulations, section 412 of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (115 Stat. 38) (2001 Act) amended section 221 by eliminating the 60-month limitation period and the restriction on deductions of interest a taxpayer pays during a period when the lender does not require payments. The 2001 Act also increased the income limitations relating to interest deductions under section 221 from $55,000 ($75,000 for married individuals filing jointly) to $65,000 ($130,000 for married individuals filing jointly) and the income phase-out range from $40,000-$55,000 ($60,000-$75,000 for married individuals filing jointly) to $50,000-$65,000 ($100,000-$130,000 for married individuals filing jointly).

The 2001 Act amendments apply to interest paid on qualified education loans after December 31, 2001. Accordingly, the final regulations appear in two sections to reflect the law before and after the effective date of the 2001 Act. Section 1.221-1 is applicable to periods governed by section 221 as amended in 2001, which relates to interest paid on qualified education loans after December 31, 2001, and on or before December 31, 2010. Section 1.221-2 is applicable to interest due and paid on qualified education loans after January 21, 1999, but before January 1, 2002. Taxpayers also may apply §1.221-2 to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. Unless the 2001 Act amendments are extended by future legislation, section 1.221-2 also will apply to interest due and paid on qualified education loans after December 31, 2010.

After consideration of all the comments, the proposed regulations under section 221 are adopted as amended by this Treasury decision.

On April 29, 2002, the IRS published final regulations (TD 8992) in the **Federal Register** (67 FR 20901) under section 6050S relating to information reporting for interest payments received on qualified education loans. The Taxpayer Relief Act of 1997 added section 6050S to the Code, as well as section 221.

Explanation and Summary of Comments

Many of the comments concerned issues relating to the 60-month limitation period, which the 2001 Act eliminated. These comments are discussed in 7. and 8. below because the 60-month period continues to apply to interest on qualified education loans due and paid after December 31, 1997, but before January 1, 2002, and again after December 31, 2010.

1. Treatment of Capitalized Interest and Certain Fees

Several commentators discussed the treatment of capitalized interest, loan origination fees, late fees, and certain insurance fees. Courts have defined the term "interest," for income tax purposes, as compensation paid for the use or forbearance of money. See, e.g., Deputy v. Du Pont, 308 U.S. 488 (1940). Consistent with this definition, the final regulations provide that capitalized interest is deductible as qualified education loan interest. Generally, fees, such as loan origination fees or late fees, are interest if the fees represent a charge for the use or forbearance of money. Therefore, if the fees represent compensation to the lender for the cost of specific services performed in connection with the borrower's account, the fees are not interest for Federal income tax purposes. See Rev. Rul. 69-188 (1969-1 C.B. 54), amplified by Rev. Rul. 69-582 (1969-2 C.B. 29); see also, e.g., Trivett v. Commissioner, T.C. Memo. 1977-161, *aff'd on other grounds*, 611 F.2d 655 (6th Cir. 1979) (Tax Court found that certain fees, including insurance fees, were similar to payments for services rendered and not deductible as interest).

Some commentators expressed confusion about how to apply the rules in the proposed regulations for allocating payments to principal or interest. In response to these comments, the final regulations provide guidance on the treatment and allocation of such amounts. Under the final regulations, a payment generally first applies to interest that has accrued and remains unpaid as of the date the payment is due and then applies to the outstanding principal. An example is included.

2. Interest Paid by Someone Other Than the Taxpayer

Several commentators requested guidance on the treatment of an interest payment made by someone other than the taxpayer. To provide consistency with section 221(a), the final regulations provide, "Under section 221, an individual taxpayer may deduct from gross income certain interest paid *by the taxpayer* during the taxable year on a qualified education loan." (Emphasis added.) The final regulations also clarify that certain third party payments of interest are treated as first paid to the taxpayer and then paid by the taxpayer to the lender, in a manner similar to the treatment of third party payments of tuition under §1.25A-5(b)(1). The final regulations provide for this treatment if a third party makes a payment of interest on a qualified education loan on behalf of a taxpayer.

Thus, for example, if a third party pays interest on behalf of the taxpayer, as a gift to the taxpayer, the taxpayer may deduct this interest for Federal income tax purposes, assuming fulfillment of all other requirements of section 221. Similarly, if an employer pays interest to a lender on behalf of the taxpayer, and the taxpayer as required by section 61 includes the payment in income for Federal income tax purposes, the taxpayer may deduct this interest, assuming fulfillment of all other requirements of section 221.

A commentator also recommended the allowance of a deduction to an individual even if the individual qualifies as a dependent of a taxpayer under section 151. This recommendation was not adopted because it is contrary to section 221(c).

3. Definition of Eligible Educational Institution

Several commentators suggested expanding the definition of eligible educational institution in a manner that is not consistent with the statutory definition under sections 221(d)(2) (formerly section 221(e)(2) (redesignated by the 2001 Act)) and 25A(f)(2). Accordingly, these comments were not adopted. Another commentator requested guidance on the deductibility of interest paid on a qualified education loan if the educational institution loses its status as an eligible educational institution after the end of the academic period for which the loan was incurred. The final regulations include a new example illustrating that the deductibility of interest on the loan is not affected by the institution's subsequent change in status.

4. Definition of Qualified Education Loan

The definition of qualified education loan in section 221(d)(1) (formerly section 221(e)(1) (redesignated by the 2001 Act)) provides, in part, that the indebtedness must be incurred by the taxpayer solely to pay higher education expenses that are paid within a reasonable period of time before or after the indebtedness is incurred. Several comments were received in connection with this "reasonable period of time" requirement.

One commentator suggested extending the 60-day safe harbor provided in the proposed regulations for satisfying the “reasonable period of time” requirement to 90 days or changing it so that the beginning of the safe harbor period is the earlier of 60 days prior to the start of the academic period or the end of the previous academic period. Two commentators suggested extending the safe harbor to 90 days after the end of the academic period. Another commentator expressed concern that expenses paid with loans disbursed outside the 60-day window would not satisfy the “reasonable period of time” requirement. Finally, one commentator interpreted the safe harbor to impose a 60-day limit on loans that are part of a federal postsecondary loan program.

The final regulations provide that what constitutes a reasonable period of time is determined based on all the relevant facts and circumstances. The final regulations also provide that qualified higher education expenses are treated as paid or incurred within a reasonable period of time under the following circumstances: 1) the expenses are paid with the proceeds of education loans that are part of a federal postsecondary education loan program; or 2) the expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days before the start of, and ends 90 days after the end of, the academic period to which the expenses relate.

One commentator recommended expansion of the federal loan safe harbor described above to include expenses paid with the proceeds of any non-federal loan disbursed under policies mirroring the awarding and disbursement policies governing certain federal loans. Although the final regulations do not adopt this suggestion, the IRS and Treasury Department believe that loans described by the commentator probably would fall within the 90-day safe harbor, or satisfy the "reasonable period of time" requirement based on the facts and circumstances.

Another requirement of a "qualified education loan" is that the borrower obtain the loan "solely" to pay higher education expenses. One commentator suggested that if a taxpayer refinances a qualified education loan and receives an amount in excess of the original qualified education loan, the taxpayer may take an interest deduction under section 221 for interest paid on the refinanced loan. The commentator is correct, but only if the taxpayer uses the excess amount solely to pay higher education expenses and satisfies all other requirements of a qualified education loan. Thus, if the taxpayer uses the excess amount for any other purpose, the refinanced loan is not "solely" to pay higher education expenses, and no interest paid on the loan will be deductible.

5. Miscellaneous Comments and Changes

Federal Postsecondary Education Loan Program -- The final regulations clarify that a federal postsecondary education loan program includes, but is not limited to, the Federal Perkins Loan, Federal Family Education Loan, and William D. Ford Federal Direct Loan Programs under Title IV of the Higher Education Act of 1965, and the Health Education Assistance Loan and the Nursing Student Loan Programs under Titles VII and VIII of the Public Health Service Act.

Eligible Educational Institution -- Although the Higher Education Amendments Act of 1998 moved section 481 from Title IV to Title I, the regulations do not reflect this change, as the statutory language refers to section 481 of the Higher Education Act as in effect on the date that section 221 was enacted.

Interest Charges on a University In-House Deferred Payment Plan -- One commentator requested clarification of the deductibility of interest charges on a university's in-house deferred payment plan, which is a revolving credit account that can include a variety of expenditures in addition to qualified higher education expenses. This situation is addressed by Example 6 of §1.221-1(e)(4) and Example 6 of §1.221-2(f)(4) concerning mixed use loans.

6. Refinanced and Consolidated Loans

The final regulations reserve a place for more detailed treatment of refinanced and consolidated loans.

7. Periods of Deferment or Forbearance

Prior to the 2001 Act, section 221(d) stated that a "deduction shall be allowed under this section only with respect to interest paid on any qualified education loan during the first 60 months (whether or nor consecutive) in which interest payments are required."

Some commentators recommended that the 60-month limitation period should not be suspended during a period of deferment or forbearance. Other commentators suggested that the 60-month limitation period should be suspended during all periods of deferment or forbearance, whether or not the taxpayer makes payments. Commentators also asked whether rules under which the 60-month period is not suspended apply to loans made under federal programs as well as non-federal loans.

Finally, commentators asked whether interest payments made during periods of reduced payment forbearance are deductible.

Section 221, prior to the 2001 Act, and the legislative history provide that only interest payments required under the terms of a loan are deductible. Under that provision, interest a borrower pays voluntarily during a period when payments are not required, such as during a period of deferment or forbearance or before loan repayment begins, is not deductible.

Therefore, §1.221-2 of the final regulations retains the rule that interest payments are not deductible if paid voluntarily during a period of deferment or forbearance. However, the final regulations provide that interest payments made during a period of deferment, forbearance, or reduced payment forbearance are deductible if required as part of the terms of the deferment, forbearance, or reduced payment agreement. The final regulations include a new example involving reduced payment forbearance.

In addition, §1.221-2 of the final regulations provides for suspension of the 60-month period for loans not issued or guaranteed under a federal postsecondary education loan program under certain conditions. The promissory note must contain conditions for deferment or forbearance that are substantially similar to the conditions established by the U.S. Department of Education for Federal student loan programs under Title IV of the Higher Education Act of 1965 and the borrower must satisfy one of those conditions.

8. Start of the 60-Month Limitation Period

A commentator expressed concern that the month a loan first enters repayment status may not be the same as the month the first interest payment is required. Section 1.221-2 of the final regulations clarifies that the beginning of the 60-month period commences on the first day of the month in which the first interest payment is required.

9. Information Reporting for Interest Payments Received on Qualified Education Loans

Section 6050S requires information reporting by certain lenders or other payees that receive payments of interest on qualified education loans. Section 1.6050S-3(b)(1) provides that interest includes stated interest, loan origination fees (other than fees for services), and capitalized interest. Section 1.6050S-3(e)(1) provides a special transitional rule for reporting loan origination fees and capitalized interest. Under the transitional rule, a payee is not required to report payments of loan origination fees and capitalized interest for loans made before January 1, 2004.

Several commentators representing payees requested that the transitional rule be extended because the necessary programming changes to capture and report these amounts could not be made in the absence of final regulations under section 221. Based on the comments received, these regulations amend §1.6050S-3(e)(1) to extend the transitional rule to loans made before September 1, 2004.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the

Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations that preceded 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 final regulations is Sean M. Dwyer, Office of the Associate Chief Counsel (Income Tax & Accounting). 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 record keeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 - INCOME TAXES

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

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

Section 1.221-2 also issued under 26 U.S.C. 221(d). * * *
Section 1.6050S-3 also issued under 26 U.S.C. 6050S(g). * * *

Par. 2. Sections 1.221-1 and 1.221-2 are added to read as follows:

§1.221-1 Deduction for interest paid on qualified education loans after December 31, 2001.

(a) In general--(1) Applicability. Under section 221, an individual taxpayer may deduct from gross income certain interest paid by the taxpayer during the taxable year on a qualified education loan. See paragraph (b)(4) of this section for rules on payments of interest by third parties. The rules of this section are applicable to periods governed by section 221 as amended in 2001, which relates to deductions for interest paid on qualified education loans after December 31, 2001, in taxable years ending after December 31, 2001, and on or before December 31, 2010. For rules applicable to interest due and paid on qualified education loans after January 21, 1999, if paid before January 1, 2002, see §1.221-2. Taxpayers also may apply §1.221-2 to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. To the extent that the effective date limitation (sunset) of the 2001 amendment remains in force unchanged, section 221 before amendment in 2001, to which §1.221-2 relates, also applies to interest due and paid on qualified education loans in taxable years beginning after December 31, 2010.

(2) Example. The following example illustrates the rules of this paragraph (a). In the example, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The example is as follows:

Example. Effective dates. Student A begins to make monthly interest payments on her loan beginning January 1, 1997. Student A continues to make interest payments in a timely fashion. However, under the effective date provisions of section 221, no deduction is allowed for interest Student A pays prior to January 1, 1998. Student A may deduct interest due and paid on the loan after December 31, 1997. Student A may apply the rules of §1.221-2 to interest due and paid during the period beginning January 1, 1998, and ending January 20, 1999. Interest due and paid during the period January 21, 1999, and ending December 31, 2001, is deductible under the rules of §1.221-2, and interest paid after December 31, 2001, is deductible under the rules of this section.

(b) Eligibility--(1) Taxpayer must have a legal obligation to make interest payments. A taxpayer is entitled to a deduction under section 221 only if the taxpayer has a legal obligation to make interest payments under the terms of the qualified education loan.

(2) Claimed dependents not eligible--(i) In general. An individual is not entitled to a deduction under section 221 for a taxable year if the individual is a dependent (as defined in section 152) for whom another taxpayer is allowed a deduction under section 151 on a Federal income tax return for the same taxable year (or, in the case of a fiscal year taxpayer, the taxable year beginning in the same calendar year as the individual's taxable year).

(ii) Examples. The following examples illustrate the rules of this paragraph (b)(2):

Example 1. Student not claimed as dependent. Student B pays $750 of interest on qualified education loans during 2003. Student B's parents are not allowed a deduction for her as a dependent for 2003. Assuming fulfillment of all other relevant requirements, Student B may deduct under section 221 the $750 of interest paid in 2003.

Example 2. Student claimed as dependent. Student C pays $750 of interest on qualified education loans during 2003. Only Student C has the legal obligation to make the payments. Student C's parent claims him as a dependent and is allowed a deduction under section 151 with respect to Student C in computing the parent's 2003 Federal income tax. Student C is not entitled to a deduction under section 221 for the $750 of interest paid in 2003. Because Student C's parent was not legally obligated to make the payments, Student C's parent also is not entitled to a deduction for the interest.

(3) Married taxpayers. If a taxpayer is married as of the close of a taxable year, he or she is entitled to a deduction under this section only if the taxpayer and the taxpayer's spouse file a joint return for that taxable year.

(4) Payments of interest by a third party -- (i) In general. If a third party who is

not legally obligated to make a payment of interest on a qualified education loan makes a payment of interest on behalf of a taxpayer who is legally obligated to make the payment, then the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest.

(ii) Examples. The following examples illustrate the rules of this paragraph (b)(4):

Example 1. Payment by employer. Student D obtains a qualified education loan to attend college. Upon Student D's graduation from college, Student D works as an intern for a non-profit organization during which time Student D's loan is in deferment and Student D makes no interest payments. As part of the internship program, the non-profit organization makes an interest payment on behalf of Student D after the deferment period. This payment is not excluded from Student D's income under section 108(f) and is treated as additional compensation includible in Student D's gross income. Assuming fulfillment of all other requirements of section 221, Student D may deduct this payment of interest for Federal income tax purposes.

Example 2. Payment by parent. Student E obtains a qualified education loan to attend college. Upon graduation from college, Student E makes legally required monthly payments of principal and interest. Student E's mother makes a required monthly payment of interest as a gift to Student E. A deduction for Student E as a dependent is not allowed on another taxpayer's tax return for that taxable year. Assuming fulfillment of all other requirements of section 221, Student E may deduct this payment of interest for Federal income tax purposes.

(c) Maximum deduction. The amount allowed as a deduction under section 221 for any taxable year may not exceed $2,500.

(d) Limitation based on modified adjusted gross income--(1) In general. The deduction allowed under section 221 is phased out ratably for taxpayers with modified adjusted gross income between $50,000 and $65,000 ($100,000 and $130,000 for married individuals who file a joint return). Section 221 does not allow a deduction for taxpayers with modified adjusted gross income of $65,000 or above ($130,000 or above for married individuals who file a joint return). See paragraph (d)(3) of this section for inflation adjustment of amounts in this paragraph (d)(1).

(2) Modified adjusted gross income defined. The term modified adjusted gross income means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain United States possessions or Puerto Rico). Modified adjusted gross income must be determined under this section after taking into account the inclusions, exclusions, deductions, and limitations provided by sections 86 (social security and tier 1 railroad retirement benefits), 135 (redemption of qualified United States savings bonds), 137 (adoption assistance programs), 219 (deductible qualified retirement contributions), and 469 (limitation on passive activity losses and credits), but before taking into account the deductions provided by sections 221 and 222 (qualified tuition and related expenses).

(3) Inflation adjustment. For taxable years beginning after 2002, the amounts in paragraph (d)(1) of this section will be increased for inflation occurring after 2001 in accordance with section 221(f)(1). If any amount adjusted under section 221(f)(1) is not a multiple of $5,000, the amount will be rounded to the next lowest multiple of $5,000.

(e) Definitions--(1) Eligible educational institution. In general, an eligible educational institution means any college, university, vocational school, or other postsecondary educational institution described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on August 5, 1997, and certified by the U.S. Department of Education as eligible to participate in student aid programs administered by the Department, as described in section 25A(f)(2) and §1.25A-2(b). For purposes of this section, an eligible educational institution also includes an institution that conducts an internship or residency program leading to a degree or certificate awarded by an institution, a hospital, or a health care facility that offers postgraduate training.

(2) Qualified higher education expenses--(i) In general. Qualified higher education expenses means the cost of attendance (as defined in section 472 of the Higher Education Act of 1965, 20 U.S.C. 1087ll, as in effect on August 4, 1997), at an eligible educational institution, reduced by the amounts described in paragraph (e)(2)(ii) of this section. Consistent with section 472 of the Higher Education Act of 1965, a student's cost of attendance is determined by the eligible educational institution and includes tuition and fees normally assessed a student carrying the same academic workload as the student, an allowance for room and board, and an allowance for books, supplies, transportation, and miscellaneous expenses of the student.

(ii) Reductions. Qualified higher education expenses are reduced by any amount that is paid to or on behalf of a student with respect to such expenses and that is--

(A) A qualified scholarship that is excludable from income under section 117;

(B) An educational assistance allowance for a veteran or member of the armed forces under chapter 30, 31, 32, 34 or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(C) Employer-provided educational assistance that is excludable from income under section 127;

(D) Any other amount that is described in section 25A(g)(2)(C) (relating to amounts excludable from gross income as educational assistance);

(E) Any otherwise includible amount excluded from gross income under section 135 (relating to the redemption of United States savings bonds);

(F) Any otherwise includible amount distributed from a Coverdell education savings account and excluded from gross income under section 530(d)(2); or

(G) Any otherwise includible amount distributed from a qualified tuition program and excluded from gross income under section 529(c)(3)(B).

(3) Qualified education loan--(i) In general. A qualified education loan means indebtedness incurred by a taxpayer solely to pay qualified higher education expenses that are--

(A) Incurred on behalf of a student who is the taxpayer, the taxpayer's spouse, or a dependent (as defined in section 152) of the taxpayer at the time the taxpayer incurs the indebtedness;

(B) Attributable to education provided during an academic period, as described in section 25A and the regulations thereunder, when the student is an eligible student as defined in section 25A(b)(3) (requiring that the student be a degree candidate carrying at least half the normal full-time workload); and

(C) Paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness.

(ii) Reasonable Period. Except as otherwise provided in this paragraph (e)(3)(ii), what constitutes a reasonable period of time for purposes of paragraph (e)(3)(i)(C) of this section generally is determined based on all the relevant facts and circumstances. However, qualified higher education expenses are treated as paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness if--

(A) The expenses are paid with the proceeds of education loans that are part of a Federal postsecondary education loan program; or

(B) The expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of that academic period and ends 90 days after the end of that academic period.

(iii) Related party. A qualified education loan does not include any indebtedness owed to a person who is related to the taxpayer, within the meaning of section 267(b) or 707(b)(1). For example, a parent or grandparent of the taxpayer is a related person. In addition, a qualified education loan does not include a loan made under any qualified employer plan as defined in section 72(p)(4) or under any contract referred to in section 72(p)(5).

(iv) Federal issuance or guarantee not required. A loan does not have to be issued or guaranteed under a Federal postsecondary education loan program to be a qualified education loan.

(v) Refinanced and consolidated indebtedness--(A) In general. A qualified education loan includes indebtedness incurred solely to refinance a qualified education loan. A qualified education loan includes a single, consolidated indebtedness incurred solely to refinance two or more qualified education loans of a borrower.

(B) Treatment of refinanced and consolidated indebtedness. [*Reserved.*]

(4) Examples. The following examples illustrate the rules of this paragraph (e):

Example 1. Eligible educational institution. University F is a postsecondary educational institution described in section 481 of the Higher Education Act of 1965.

The U.S. Department of Education has certified that University F is eligible to participate in federal financial aid programs administered by that Department, although University F chooses not to participate. University F is an eligible educational institution.

Example 2. Qualified higher education expenses. Student G receives a $3,000 qualified scholarship for the 2003 fall semester that is excludable from Student G's gross income under section 117. Student G receives no other forms of financial assistance with respect to the 2003 fall semester. Student G's cost of attendance for the 2003 fall semester, as determined by Student G's eligible educational institution for purposes of calculating a student's financial need in accordance with section 472 of the Higher Education Act, is $16,000. For the 2003 fall semester, Student G has qualified higher education expenses of $13,000 (the cost of attendance as determined by the institution ($16,000) reduced by the qualified scholarship proceeds excludable from gross income ($3,000)).

Example 3. Qualified education loan. Student H borrows money from a commercial bank to pay qualified higher education expenses related to his enrollment on a half-time basis in a graduate program at an eligible educational institution. Student H uses all the loan proceeds to pay qualified higher education expenses incurred within a reasonable period of time after incurring the indebtedness. The loan is not federally guaranteed. The commercial bank is not related to Student H within the meaning of section 267(b) or 707(b)(1). Student H's loan is a qualified education loan within the meaning of section 221.

Example 4. Qualified education loan. Student I signs a promissory note for a loan on August 15, 2003, to pay for qualified higher education expenses for the 2003 fall and 2004 spring semesters. On August 20, 2003, the lender disburses loan proceeds to Student I's college. The college credits them to Student I's account to pay qualified higher education expenses for the 2003 fall semester, which begins on August 25, 2003. On January 26, 2004, the lender disburses additional loan proceeds to Student I's college. The college credits them to Student I's account to pay qualified higher education expenses for the 2004 spring semester, which began on January 12, 2004. Student I's qualified higher education expenses for the two semesters are paid within a reasonable period of time, as the first loan disbursement occurred within the 90 days prior to the start of the fall 2003 semester and the second loan disbursement occurred during the spring 2004 semester.

Example 5. Qualified education loan. The facts are the same as in Example 4 except that in 2005 the college is not an eligible educational institution because it loses its eligibility to participate in certain federal financial aid programs administered by the U.S. Department of Education. The qualification of Student I's loan, which was used to pay for qualified higher education expenses for the 2003 fall and 2004 spring semesters, as a qualified education loan is not affected by the college's subsequent loss of eligibility.

Example 6. Mixed-use loans. Student J signs a promissory note for a loan secured by Student J's personal residence. Student J will use part of the loan proceeds to pay for certain improvements to Student J's residence and part of the loan proceeds to pay qualified higher education expenses of Student J's spouse. Because Student J obtains the loan not solely to pay qualified higher education expenses, the loan is not a qualified education loan.

(f) Interest--(1) In general. Amounts paid on a qualified education loan are deductible under section 221 if the amounts are interest for federal income tax purposes. For example, interest includes--

(i) Qualified stated interest (as defined in §1.1273-1(c)); and

(ii) Original issue discount, which generally includes capitalized interest. For purposes of section 221, capitalized interest means any accrued and unpaid interest on a qualified education loan that, in accordance with the terms of the loan, is added by the lender to the outstanding principal balance of the loan.

(2) Operative rules for original issue discount--(i) In general. The rules to determine the amount of original issue discount on a loan and the accruals of the discount are in sections 163(e), 1271 through 1275, and the regulations thereunder. In general, original issue discount is the excess of a loan's stated redemption price at maturity (all payments due under the loan other than qualified stated interest payments) over its issue price (the amount loaned). Although original issue discount generally is deductible as it accrues under section 163(e) and §1.163-7, original issue discount on a qualified education loan is not deductible until paid. See paragraph (f)(3) of this section to determine when original issue discount is paid.

(ii) Treatment of loan origination fees by the borrower. If a loan origination fee is paid by the borrower other than for property or services provided by the lender, the fee reduces the issue price of the loan, which creates original issue discount (or additional original issue discount) on the loan in an amount equal to the fee. See §1.1273-2(g). For an example of how a loan origination fee is taken into account, see Example 2 of paragraph (f)(4) of this section.

(3) Allocation of payments. See §§1.446-2(e) and 1.1275-2(a) for rules on allocating payments between interest and principal. In general, these rules treat a payment first as a payment of interest to the extent of the interest that has accrued and remains unpaid as of the date the payment is due, and second as a payment of principal. The characterization of a payment as either interest or principal under these rules applies regardless of how the parties label the payment (either as interest or principal). Accordingly, the taxpayer may deduct the portion of a payment labeled as principal that these rules treat as a payment of interest on the loan, including any portion attributable to capitalized interest or loan origination fees.

(4) Examples. The following examples illustrate the rules of this paragraph (f). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The examples are as follows:

Example 1. Capitalized interest. Interest on Student K's loan accrues while Student K is in school, but Student K is not required to make any payments on the loan until six months after he graduates or otherwise leaves school. At that time, the lender capitalizes all accrued but unpaid interest and adds it to the outstanding principal amount of the loan. Thereafter, Student K is required to make monthly payments of interest and principal on the loan. The interest payable on the loan, including the capitalized interest, is original issue discount. See section 1273 and the regulations thereunder. Therefore, in determining the total amount of interest paid on the loan each taxable year, Student K may deduct any payments that §1.1275-2(a) treats as payments of interest, including any principal payments that are treated as payments of capitalized interest. See paragraph (f)(3) of this section.

Example 2. Allocation of payments. The facts are the same as in Example 1, except that, in addition, the lender charges Student K a loan origination fee, which is not for any property or services provided by the lender. Under §1.1273-2(g), the loan origination fee reduces the issue price of the loan, which reduction increases the amount of original issue discount on the loan by the amount of the fee. The amount of original issue discount (which includes the capitalized interest and loan origination fee) that accrues each year is determined under section 1272 and §1.1272-1. In effect, the loan origination fee accrues over the entire term of the loan. Because the loan has original issue discount, the payment ordering rules in §1.1275-2(a) must be used to determine how much of each payment is interest for federal tax purposes. See paragraph (f)(3) of this section. Under §1.1275-2(a), each payment (regardless of its designation by the parties as either interest or principal) generally is treated first as a payment of original issue discount, to the extent of the original issue discount that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Therefore, in determining the total amount of interest paid on the qualified education loan for a taxable year, Student K may deduct any payments that the parties label as principal but that are treated as payments of original issue discount under §1.1275-2(a).

(g) Additional Rules--(1) Payment of interest made during period when interest payment not required. Payments of interest on a qualified education loan to which this section is applicable are deductible even if the payments are made during a period when interest payments are not required because, for example, the loan has not yet entered repayment status or is in a period of deferment or forbearance.

(2) Denial of double benefit. No deduction is allowed under this section for any amount for which a deduction is allowable under another provision of Chapter 1 of the Internal Revenue Code. No deduction is allowed under this section for any amount for which an exclusion is allowable under section 108(f) (relating to cancellation of indebtedness).

(3) Examples. The following examples illustrate the rules of this paragraph (g). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, and the student is legally obligated to make interest payments under the terms of the loan:

Example 1. Voluntary payment of interest before loan has entered repayment status. Student L obtains a loan to attend college. The terms of the loan provide that interest accrues on the loan while Student L earns his undergraduate degree but that Student L is not required to begin making payments of interest until six full calendar months after he graduates or otherwise leaves school. Nevertheless, Student L voluntarily pays interest on the loan during 2003, while enrolled in college. Assuming all other relevant requirements are met, Student L is allowed a deduction for interest paid while attending college even though the payments were made before interest payments were required.

Example 2. Voluntary payment during period of deferment or forbearance. The facts are the same as in Example 2, except that Student L makes no payments on the loan while enrolled in college. Student L graduates in June 2003 and begins making monthly payments of principal and interest on the loan in January 2004, as required by the terms of the loan. In August 2004, Student L enrolls in graduate school on a full-time basis. Under the terms of the loan, Student L may apply for deferment of the loan payments while Student L is enrolled in graduate school. Student L applies for and receives a deferment on the outstanding loan. However, Student L continues to make some monthly payments of interest during graduate school. Student L may deduct interest paid on the loan during the period beginning in January 2004, including interest paid while Student L is enrolled in graduate school.

(h) Effective date. This section is applicable to periods governed by section 221 as amended in 2001, which relates to interest paid on a qualified education loan after December 31, 2001, in taxable years ending after December 31, 2001, and on or before December 31, 2010.

§1.221-2 Deduction for interest due and paid on qualified education loans before January 1, 2002.

(a) In general. Under section 221, an individual taxpayer may deduct from gross income certain interest due and paid by the taxpayer during the taxable year on a qualified education loan. The deduction is allowed only with respect to interest due and paid on a qualified education loan during the first 60 months that interest payments are required under the terms of the loan. See paragraph (e) of this section for rules relating to the 60-month rule. See paragraph (b)(4) of this section for rules on payments of interest by third parties. The rules of this section are applicable to interest due and paid on qualified education loans after January 21, 1999, if paid before January 1, 2002. Taxpayers also may apply the rules of this section to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. To the extent that the effective date limitation ("sunset") of the 2001 amendment remains in force unchanged, section 221 before amendment in 2001, to which this section relates, also applies to interest due and paid on qualified education loans in taxable years beginning after December 31, 2010. For rules applicable to periods governed by section 221 as amended in 2001, which relates to deductions for interest paid on qualified education loans after December 31, 2001, in taxable years ending after December 31, 2001, and before January 1, 2011, see §1.221-1.

(b) Eligibility--(1) Taxpayer must have a legal obligation to make interest payments. A taxpayer is entitled to a deduction under section 221 only if the taxpayer has a legal obligation to make interest payments under the terms of the qualified education loan.

(2) Claimed dependents not eligible--(i) In general. An individual is not entitled to a deduction under section 221 for a taxable year if the individual is a dependent (as

defined in section 152) for whom another taxpayer is allowed a deduction under section 151 on a Federal income tax return for the same taxable year (or, in the case of a fiscal year taxpayer, the taxable year beginning in the same calendar year as the individual's taxable year).

(ii) Examples. The following examples illustrate the rules of this paragraph (b)(2):

Example 1. Student not claimed as dependent. Student A pays $750 of interest on qualified education loans during 1998. Student A's parents are not allowed a deduction for her as a dependent for 1998. Assuming fulfillment of all other relevant requirements, Student A may deduct the $750 of interest paid in 1998 under section 221.

Example 2. Student claimed as dependent. Student B pays $750 of interest on qualified education loans during 1998. Only Student B has the legal obligation to make the payments. Student B's parent claims him as a dependent and is allowed a deduction under section 151 with respect to Student B in computing the parent's 1998 Federal income tax. Student B may not deduct the $750 of interest paid in 1998 under section 221. Because Student B's parent was not legally obligated to make the payments, Student B's parent also may not deduct the interest.

(3) Married taxpayers. If a taxpayer is married as of the close of a taxable year, he or she is entitled to a deduction under this section only if the taxpayer and the taxpayer's spouse file a joint return for that taxable year.

(4) Payments of interest by a third party--(i) In general. If a third party who is not legally obligated to make a payment of interest on a qualified education loan makes a payment of interest on behalf of a taxpayer who is legally obligated to make the payment, then the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest.

(ii) Examples. The following examples illustrate the rules of this paragraph (b)(4):

Example 1. Payment by employer. Student C obtains a qualified education loan to attend college. Upon Student C's graduation from college, Student C works as an intern for a non-profit organization during which time Student C's loan is in deferment and Student C makes no interest payments. As part of the internship program, the non-profit organization makes an interest payment on behalf of Student C after the deferment period. This payment is not excluded from Student C's income under section 108(f) and is treated as additional compensation includible in Student C's gross income. Assuming fulfillment of all other requirements of section 221, Student C may deduct this payment of interest for Federal income tax purposes.

Example 2. Payment by parent. Student D obtains a qualified education loan to attend college. Upon graduation from college, Student D makes legally required monthly payments of principal and interest. Student D's mother makes a required monthly payment of interest as a gift to Student D. A deduction for Student D as a dependent is not allowed on another taxpayer's tax return for that taxable year. Assuming fulfillment of all other requirements of section 221, Student D may deduct this payment of interest for Federal income tax purposes.

(c) Maximum deduction. In any taxable year beginning before January 1, 2002, the amount allowed as a deduction under section 221 may not exceed the amount determined in accordance with the following table:

Taxable Year Beginning in	Maximum Deduction
1998	$1,000
1999	$1,500
2000	$2,000
2001	$2,500

(d) Limitation based on modified adjusted gross income--(1) In general. The deduction allowed under section 221 is phased out ratably for taxpayers with modified adjusted gross income between $40,000 and $55,000 ($60,000 and $75,000 for married individuals who file a joint return). Section 221 does not allow a deduction for taxpayers with modified adjusted gross income of $55,000 or above ($75,000 or above for married individuals who file a joint return).

(2) Modified adjusted gross income defined. The term modified adjusted gross income means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain United States possessions or Puerto Rico). Modified adjusted gross income must be determined under this section after taking into account the inclusions, exclusions, deductions, and limitations provided by sections 86 (social security and tier 1 railroad retirement benefits), 135 (redemption of qualified United States savings bonds), 137 (adoption assistance programs), 219 (deductible qualified retirement contributions), and 469 (limitation on passive activity losses and credits), but before taking into account the deduction provided by section 221.

(e) 60-month rule--(1) In general. A deduction for interest paid on a qualified education loan is allowed only for payments made during the first 60 months that interest payments are required on the loan. The 60-month period begins on the first day of the month that includes the date on which interest payments are first required and ends 60 months later, unless the 60-month period is suspended for periods of deferment or forbearance within the meaning of paragraph (e)(3) of this section. The 60-month period continues to run regardless of whether the required interest payments are actually made. The date on which the first interest payment is required is determined under the terms of the loan agreement or, in the case of a loan issued or guaranteed under a federal postsecondary education loan program (such as loan programs under Title IV of the Higher Education Act of 1965 (20 U.S.C. 1070) and Titles

VII and VIII of the Public Health Service Act (42 U.S.C. 292, and 42 U.S.C. 296) under applicable Federal regulations. For a discussion of interest, see paragraph (h) of this section. For special rules relating to loan refinancings, consolidated loans, and collapsed loans, see paragraph (i) of this section.

(2) Loans that entered repayment status prior to January 1, 1998. In the case of any qualified education loan that entered repayment status prior to January 1, 1998, section 221 allows no deduction for interest paid during the portion of the 60-month period described in paragraph (e)(1) of this section that occurred prior to January 1, 1998. Section 221 allows a deduction only for interest due and paid during that portion, if any, of the 60-month period remaining after December 31, 1997.

(3) Periods of deferment or forbearance. The 60-month period described in paragraph (e)(1) of this section generally is suspended for any period when interest payments are not required on a qualified education loan because the lender has granted the taxpayer a period of deferment or forbearance (including postponement in anticipation of cancellation). However, in the case of a qualified education loan that is not issued or guaranteed under a Federal postsecondary education loan program, the 60-month period will be suspended under this paragraph (e)(3) only if the promissory note contains conditions substantially similar to the conditions for deferment or forbearance established by the U.S. Department of Education for Federal student loan programs under Title IV of the Higher Education Act of 1965, such as half-time study at a postsecondary educational institution, study in an approved graduate fellowship program or in an approved rehabilitation program for the disabled, inability to find full-

time employment, economic hardship, or the performance of services in certain occupations or federal programs, and the borrower satisfies one of those conditions. For any qualified education loan, the 60-month period is not suspended if under the terms of the loan interest continues to accrue while the loan is in deferment or forbearance and either--

(i) In the case of deferment, the taxpayer agrees to pay interest currently during the deferment period; or

(ii) In the case of forbearance, the taxpayer agrees to make reduced payments, or payments of interest only, during the forbearance period.

(4) Late payments. A deduction is allowed for a payment of interest required in one month but actually made in a subsequent month prior to the expiration of the 60-month period. A deduction is not allowed for a payment of interest required in one month but actually made in a subsequent month after the expiration of the 60-month period. A late payment made during a period of deferment or forbearance is treated, solely for purposes of determining whether it is made during the 60-month period, as made on the date it is due.

(5) Examples. The following examples illustrate the rules of this paragraph (e). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan and is issued or guaranteed under a federal postsecondary education loan program, the student is legally obligated to make interest payments under the terms of the loan, the interest payments occur after December 31, 1997, but before January 1, 2002, and with respect to any period

after December 31, 1997, but before January 21, 1999, the taxpayer elects to apply the rules of this section. The examples are as follows:

Example 1. Payment prior to 60-month period. Student E obtains a loan to attend college. The terms of the loan provide that interest accrues on the loan while Student E earns his undergraduate degree but that Student E is not required to begin making payments of interest until six full calendar months after he graduates. Nevertheless, Student E voluntarily pays interest on the loan while attending college. Student E is not allowed a deduction for interest paid during that period, because those payments were made prior to the start of the 60-month period. Similarly, Student E would not be allowed a deduction for any interest paid during the six month grace period after graduation when interest payments are not required.

Example 2. Deferment option not exercised. The facts are the same as in Example 1 except that Student E makes no payments on the loan while enrolled in college. Student E graduates in June 1999, and is required to begin making monthly payments of principal and interest on the loan in January 2000. The 60-month period described in paragraph (e)(1) of this section begins in January 2000. In August 2000, Student E enrolls in graduate school on a full-time basis. Under the terms of the loan, Student E may apply for deferment of the loan payments while enrolled in graduate school. However, Student E elects not to apply for deferment and continues to make required monthly payments on the loan during graduate school. Assuming fulfillment of all other relevant requirements, Student E may deduct interest paid on the loan during the 60-month period beginning in January 2000, including interest paid while enrolled in graduate school.

Example 3. Late payment, within 60-month period. The facts are the same as in Example 2 except that, after the loan enters repayment status in January 2000, Student E makes no interest payments until March 2000. In March 2000, Student E pays interest required for the months of January, February, and March 2000. Assuming fulfillment of all other relevant requirements, Student E may deduct the interest paid in March for the months of January, February, and March because the interest payments are required under the terms of the loan and are paid within the 60-month period, even though the January and February interest payments may be late.

Example 4. Late payment during deferment but within 60-month period. The terms of Student F's loan require her to begin making monthly payments of interest on the loan in January 2000. The 60-month period described in paragraph (e)(1) of this section begins in January 2000. Student F fails to make the required interest payments for the months of November and December 2000. In January 2001, Student F enrolls in graduate school on a half-time basis. Under the terms of the loan, Student F obtains a deferment of the loan payments due while enrolled in graduate school. The deferment becomes effective January 1, 2001. In March 2001, while the loan is in deferment, Student F pays the interest due for the months of November and December 2000. Assuming fulfillment of all other relevant requirements, Student F may deduct interest paid in March 2001, for the months of November and December 2000, because the late interest payments are treated, solely for purposes of determining whether they were made during the 60-month period, as made in November and December 2000.

Example 5. 60-month period. The terms of Student G's loan require him to begin making monthly payments of interest on the loan in November 1999. The 60-month period described in paragraph (e)(1) of this section begins in November 1999. In January 2000, Student G enrolls in graduate school on a half-time basis. As permitted under the terms of the loan, Student G applies for deferment of the loan payments due while enrolled in graduate school. While awaiting formal approval from the lender of his request for deferment, Student G pays interest due for the month of January 2000. In February 2000, the lender approves Student G's request for deferment, effective as of January 1, 2000. Assuming fulfillment of all other relevant requirements, Student G may deduct interest paid in January 2000, prior to his receipt of the lender's approval, even though the deferment was retroactive to January 1, 2000. As of February 2000, there are 57 months remaining in the 60-month period for that loan. Because Student G is not required to make interest payments during the period of deferment, the 60-month period is suspended. After January 2000, Student G may not deduct any voluntary payments of interest made during the period of deferment.

Example 6. 60-month period. The terms of Student H's loan require her to begin making monthly payments of interest on the loan in November 1999. The 60-month period described in paragraph (e)(1) of this section begins in November 1999. In January 2000, Student H enrolls in graduate school on a half-time basis. As permitted under the terms of the loan, Student H applies to make reduced payments of principal and interest while enrolled in graduate school. After the lender approves her application, Student H pays principal and interest due for the month of January 2000 at the reduced rate. Assuming fulfillment of all other relevant requirements, Student H may deduct interest paid in January 2000. As of February 2000, there are 57 months remaining in the 60-month period for that loan.

Example 7. Reduction of 60-month period for months prior to January 1, 1998. The first payment of interest on a loan is due in January 1997. Thereafter, interest payments are required on a monthly basis. The 60-month period described in paragraph (e)(1) of this section for this loan begins on January 1, 1997, the first day of the month that includes the date on which the first interest payment is required. However, the borrower may not deduct interest paid prior to January 1, 1998, under the effective date provisions of section 221. Assuming fulfillment of all other relevant requirements, the borrower may deduct interest due and paid on the loan during the 48 months beginning on January 1, 1998 (unless such period is extended for periods of deferment or forbearance under paragraph (e)(3) of this section).

(f) Definitions--(1) Eligible educational institution. In general, an eligible educational institution means any college, university, vocational school, or other post-secondary educational institution described in section 481 of the Higher Education Act of 1965, 20 U.S.C. 1088, as in effect on August 5, 1997, and certified by the U.S. Department of Education as eligible to participate in student aid programs administered by the Department, as described in section 25A(f)(2) and § 1.25A-2(b). For purposes of this section, an eligible educational institution also includes an institution that conducts an internship or residency program leading to a degree or certificate awarded by an institution, a hospital, or a health care facility that offers postgraduate training.

(2) Qualified higher education expenses--(i) In general. Qualified higher education expenses means the cost of attendance (as defined in section 472 of the Higher Education Act of 1965, 20 U.S.C. 1087ll, as in effect on August 4, 1997), at an eligible educational institution, reduced by the amounts described in paragraph (f)(2)(ii) of this section. Consistent with section 472 of the Higher Education Act of 1965, a student's cost of attendance is determined by the eligible educational institution and includes tuition and fees normally assessed a student carrying the same academic workload as the student, an allowance for room and board, and an allowance for books, supplies, transportation, and miscellaneous expenses of the student.

(ii) Reductions. Qualified higher education expenses are reduced by any amount that is paid to or on behalf of a student with respect to such expenses and that is--

(A) A qualified scholarship that is excludable from income under section 117;

(B) An educational assistance allowance for a veteran or member of the armed forces under chapter 30, 31, 32, 34 or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(C) Employer-provided educational assistance that is excludable from income under section 127;

(D) Any other amount that is described in section 25A(g)(2)(C) (relating to amounts excludable from gross income as educational assistance);

(E) Any otherwise includible amount excluded from gross income under section 135 (relating to the redemption of United States savings bonds); or

(F) Any otherwise includible amount distributed from a Coverdell education savings account and excluded from gross income under section 530(d)(2).

(3) Qualified education loan--(i) In general. A qualified education loan means indebtedness incurred by a taxpayer solely to pay qualified higher education expenses that are--

(A) Incurred on behalf of a student who is the taxpayer, the taxpayer's spouse, or a dependent (as defined in section 152) of the taxpayer at the time the taxpayer incurs the indebtedness;

(B) Attributable to education provided during an academic period, as described in section 25A and the regulations thereunder, when the student is an eligible student as defined in section 25A(b)(3) (requiring that the student be a degree candidate carrying at least half the normal full-time workload); and

(C) Paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness.

(ii) Reasonable period. Except as otherwise provided in this paragraph (f)(3)(ii), what constitutes a reasonable period of time for purposes of paragraph (f)(3)(i)(C) of this section generally is determined based on all the relevant facts and circumstances. However, qualified higher education expenses are treated as paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness if--

(A) The expenses are paid with the proceeds of education loans that are part of a federal postsecondary education loan program; or

(B) The expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of that academic period and ends 90 days after the end of that academic period.

(iii) Related party. A qualified education loan does not include any indebtedness owed to a person who is related to the taxpayer, within the meaning of section 267(b) or 707(b)(1). For example, a parent or grandparent of the taxpayer is a related person. In addition, a qualified education loan does not include a loan made under any qualified employer plan as defined in section 72(p)(4) or under any contract referred to in section 72(p)(5).

(iv) Federal issuance or guarantee not required. A loan does not have to be issued or guaranteed under a federal postsecondary education loan program to be a qualified education loan.

(v) Refinanced and consolidated indebtedness--(A) In general. A qualified education loan includes indebtedness incurred solely to refinance a qualified education loan. A qualified education loan includes a single, consolidated indebtedness incurred solely to refinance two or more qualified education loans of a borrower.

(B) Treatment of refinanced and consolidated indebtedness. [*Reserved.*]

(4) Examples. The following examples illustrate the rules of this paragraph (f):

Example 1. Eligible educational institution. University J is a postsecondary educational institution described in section 481 of the Higher Education Act of 1965. The U.S. Department of Education has certified that University J is eligible to participate in federal financial aid programs administered by that Department, although University J chooses not to participate. University J is an eligible educational institution.

Example 2. Qualified higher education expenses. Student K receives a $3,000 qualified scholarship for the 1999 fall semester that is excludable from Student K's gross income under section 117. Student K receives no other forms of financial assistance with respect to the 1999 fall semester. Student K's cost of attendance for the 1999 fall semester, as determined by Student K's eligible educational institution for purposes of calculating a student's financial need in accordance with section 472 of the Higher Education Act, is $16,000. For the 1999 fall semester, Student K has qualified higher education expenses of $13,000 (the cost of attendance as determined by the institution ($16,000) reduced by the qualified scholarship proceeds excludable from gross income ($3,000)).

Example 3. Qualified education loan. Student L borrows money from a commercial bank to pay qualified higher education expenses related to his enrollment on a half-time basis in a graduate program at an eligible educational institution. Student L uses all the loan proceeds to pay qualified higher education expenses incurred within a reasonable period of time after incurring the indebtedness. The loan is not federally guaranteed. The commercial bank is not related to Student L within the meaning of section 267(b) or 707(b)(1). Student L's loan is a qualified education loan within the meaning of section 221.

Example 4. Qualified education loan. Student M signs a promissory note for a loan on August 15, 1999, to pay for qualified higher education expenses for the 1999 fall and 2000 spring semesters. On August 20, 1999, the lender disburses loan proceeds to Student M's college. The college credits them to Student M's account to pay qualified higher education expenses for the 1999 fall semester, which begins on August 23, 1999. On January 25, 2000, the lender disburses additional loan proceeds to Student M's college. The college credits them to Student M's account to pay qualified higher education expenses for the 2000 spring semester, which began on January 10, 2000. Student M's qualified higher education expenses for the two semesters are paid within a reasonable period of time, as the first loan disbursement occurred within the 90 days prior to the start of the fall 1999 semester, and the second loan disbursement occurred during the spring 2000 semester.

Example 5. Qualified education loan. The facts are the same as in Example 4, except that in 2001 the college is not an eligible educational institution because it loses its eligibility to participate in certain federal financial aid programs administered by the U.S. Department of Education. The qualification of Student M's loan, which was used to pay for qualified higher education expenses for the 1999 fall and 2000 spring semesters, as a qualified education loan is not affected by the college's subsequent loss of eligibility.

Example 6. Mixed-use loans. Student N signs a promissory note for a loan that is secured by Student N's personal residence. Student N will use part of the loan proceeds to pay for certain improvements to Student N's residence and part of the loan proceeds to pay qualified higher education expenses of Student N's spouse. Because Student N obtains the loan not solely to pay qualified higher education expenses, the loan is not a qualified education loan.

(g) Denial of double benefit. No deduction is allowed under this section for any amount for which a deduction is allowable under another provision of Chapter 1 of the Internal Revenue Code. No deduction is allowed under this section for any amount for which an exclusion is allowable under section 108(f) (relating to cancellation of indebtedness).

(h) Interest--(1) In general. Amounts paid on a qualified education loan are deductible under section 221 if the amounts are interest for Federal income tax purposes. For example, interest includes--

(i) Qualified stated interest (as defined in §1.1273-1(c)); and

(ii) Original issue discount, which generally includes capitalized interest. For purposes of section 221, capitalized interest means any accrued and unpaid interest on a qualified education loan that, in accordance with the terms of the loan, is added by the lender to the outstanding principal balance of the loan.

(2) Operative rules for original issue discount--(i) In general. The rules to determine the amount of original issue discount on a loan and the accruals of the discount are in sections 163(e), 1271 through 1275, and the regulations thereunder. In general, original issue discount is the excess of a loan's stated redemption price at maturity (all payments due under the loan other than qualified stated interest payments) over its issue price (the amount loaned). Although original issue discount generally is deductible as it accrues under section 163(e) and §1.163-7, original issue discount on a qualified education loan is not deductible until paid. See paragraph (h)(3) of this section to determine when original issue discount is paid.

(ii) Treatment of loan origination fees by the borrower. If a loan origination fee is paid by the borrower other than for property or services provided by the lender, the fee reduces the issue price of the loan, which creates original issue discount (or additional original issue discount) on the loan in an amount equal to the fee. See §1.1273-2(g). For an example of how a loan origination fee is taken into account, see Example 2 of paragraph (h)(4) of this section.

(3) Allocation of payments. See §§1.446-2(e) and 1.1275-2(a) for rules on allocating payments between interest and principal. In general, these rules treat a payment first as a payment of interest to the extent of the interest that has accrued and remains unpaid as of the date the payment is due, and second as a payment of

principal. The characterization of a payment as either interest or principal under these rules applies regardless of how the parties label the payment (either as interest or principal). Accordingly, the taxpayer may deduct the portion of a payment labeled as principal that these rules treat as a payment of interest on the loan, including any portion attributable to capitalized interest or loan origination fees.

(4) Examples. The following examples illustrate the rules of this paragraph (h). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The examples are as follows:

Example 1. Capitalized interest. Interest on Student O's qualified education loan accrues while Student O is in school, but Student O is not required to make any payments on the loan until six months after he graduates or otherwise leaves school. At that time, the lender capitalizes all accrued but unpaid interest and adds it to the outstanding principal amount of the loan. Thereafter, Student O is required to make monthly payments of interest and principal on the loan. The interest payable on the loan, including the capitalized interest, is original issue discount. Therefore, in determining the total amount of interest paid on the qualified education loan during the 60-month period described in paragraph (e)(1) of this section, Student O may deduct any payments that §1.1275-2(a) treats as payments of interest, including any principal payments that are treated as payments of capitalized interest. See paragraph (h)(3) of this section.

Example 2. Allocation of payments. The facts are the same as in Example 1 of this paragraph (h)(4), except that, in addition, the lender charges Student O a loan origination fee, which is not for any property or services provided by the lender. Under §1.1273-2(g), the loan origination fee reduces the issue price of the loan, which reduction increases the amount of original issue discount on the loan by the amount of the fee. The amount of original issue discount (which includes the capitalized interest and loan origination fee) that accrues each year is determined under section 1272 and §1.1272-1. In effect, the loan origination fee accrues over the entire term of the loan. Because the loan has original issue discount, the payment ordering rules in §1.1275-

2(a) must be used to determine how much of each payment is interest for federal tax purposes. See paragraph (h)(3) of this section. Under §1.1275-2(a), each payment (regardless of its designation by the parties as either interest or principal) generally is treated first as a payment of original issue discount, to the extent of the original issue discount that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Therefore, in determining the total amount of interest paid on the qualified education loan during the 60-month period described in paragraph (e)(1) of this section, Student O may deduct any payments that the parties label as principal but that are treated as payments of original issue discount under §1.1275-2(a). The 60-month period does not begin in the month in which the lender charges Student O the loan origination fee.

(i) Special rules regarding 60-month limitation--(1) Refinancing. A qualified education loan and all indebtedness incurred solely to refinance that loan constitute a single loan for purposes of calculating the 60-month period described in paragraph (e)(1) of this section.

(2) Consolidated loans. A consolidated loan is a single loan that refinances more than one qualified education loan of a borrower. For consolidated loans, the 60-month period described in paragraph (e)(1) of this section begins on the latest date on which any of the underlying loans entered repayment status and includes any subsequent month in which the consolidated loan is in repayment status.

(3) Collapsed loans. A collapsed loan is two or more qualified education loans of a single taxpayer that constitute a single qualified education loan for loan servicing purposes and for which the lender or servicer does not separately account. For a collapsed loan, the 60-month period described in paragraph (e)(1) of this section begins on the latest date on which any of the underlying loans entered repayment status and includes any subsequent month in which any of the underlying loans is in repayment status.

(4) Examples. The following examples illustrate the rules of this paragraph (i):

Example 1. Refinancing. Student P obtains a qualified education loan to pay for an undergraduate degree at an eligible educational institution. After graduation, Student P is required to make monthly interest payments on the loan beginning in January 2000. Student P makes the required interest payments for 15 months. In April 2001, Student P borrows money from another lender exclusively to repay the first qualified education loan. The new loan requires interest payments to start immediately. At the time Student P must begin interest payments on the new loan, which is a qualified education loan, there are 45 months remaining of the original 60-month period referred to in paragraph (e)(1) of this section.

Example 2. Collapsed loans. To finance his education, Student Q obtains four separate qualified education loans from Lender R. The loans enter repayment status, and their respective 60-month periods described in paragraph (e)(1) of this section begin, in July, August, September, and December of 1999. After all of Student Q's loans have entered repayment status, Lender R informs Student Q that Lender R will transfer all four loans to Lender S. Following the transfer, Lender S treats the loans as a single loan for loan servicing purposes. Lender S sends Student Q a single statement that shows the total principal and interest, and does not keep separate records with respect to each loan. With respect to the single collapsed loan, the 60-month period described in paragraph (e)(1) of this section begins in December 1999.

(j) Effective date. This section is applicable to interest due and paid on qualified education loans after January 21, 1999, if paid before January 1, 2002. Taxpayers also may apply this section to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. This section also applies to interest due and paid on qualified education loans in a taxable year beginning after December 31, 2010.

Par. 3. Section 1.6050S-3 is amended by revising paragraphs (d)(1)(iii)(B) and (e)(1) to read as follows:

§1.6050S-3 Information reporting for payments of interest on qualified education loans.

* * * * *

(d)* * * (1)* * *

(iii)* * *

(B) In the case of qualified education loans made before September 1, 2004, for which the payee does not report payments of interest other than stated interest, state that the payor may be able to deduct additional amounts (such as certain loan origination fees and capitalized interest) not reported on the statement;

* * * * *

(e) Special rules--(1) Transitional rule for reporting of loan origination fees and capitalized interest -- (i) Loans made before September 1, 2004. For qualified education loans made before September 1, 2004, a payee is not required to report payments of loan origination fees or capitalized interest or to take such payments into account in determining the $600 amount for purposes of paragraph (a)(1) of this section.

(ii) Loans made on or after September 1, 2004. For qualified education loans made on or after September 1, 2004, a payee is required to report payments of interest as described in §1.221-1(f). Under §1.221-1(f), interest includes loan origination fees that represent charges for the use or forbearance of money and capitalized interest. Under this paragraph (e)(1)(ii), a payee shall take such payments of interest into account in determining the $600 amount for purposes of paragraph (a)(1) of this section. For purposes of this section and section 6050S, interest (including capitalized interest and loan origination fees) is treated as received, and is reportable, in the year the interest is treated as paid under the allocation rules in §1.221-1(f)(3).

See §1.221-1(f) for rules relating to capitalized interest, and §1.221-1(f)(2)(ii) for rules relating to loan origination fees, on qualified education loans.

* * * * *

Deputy Commissioner for Services and Enforcement.

Approved:

Assistant Secretary of the Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1513

Treasury Issues Guidance on Transactions Involving Contested Liability Trusts

The Treasury Department and IRS today issued a revenue procedure that sets forth the exclusive administrative procedures by which taxpayers may obtain consent to change their method of accounting for transactions that improperly use contested liability trusts to attempt to accelerate deductions.

"In the interest of sound tax administration, the Service is exercising its discretion to modify the terms and conditions applicable to changes in method of accounting for these transactions," said Acting Assistant Secretary for Tax Policy Gregory Jenner. "These modifications are appropriate given the nature of these transactions and the disclosure otherwise required for many of these transactions as a result of the recently issued listing notice."

The revenue procedure applies to transfers to contested liabilities trusts identified as listed transactions in Notice 2003-77, including transfers for which the transferor has retained control over the trust assets and transfers that do not satisfy the economic performance requirement. Taxpayers that entered into contested liability trust transactions that are required to be disclosed as listed transactions must file amended returns to change their method of accounting for these transactions. Taxpayers that entered into contested liability trust transactions that are not required to be disclosed as listed transactions may either file amended returns or request a change in method of accounting. Taxpayers requesting a change in method of accounting for these transactions will be required to take the entire section 481(a) adjustment into account in the year of change.

-30-

REPORTS

- Rev. Proc. 2004-31
- Notice 2003-77

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, ' ' 461, 481; 1.461-2.)

Revenue Procedure 2004-31

SECTION 1. PURPOSE

This revenue procedure provides procedures for taxpayers to change their method of accounting for deducting under § 461(f) of the Internal Revenue Code amounts transferred to trusts in transactions described in Notice 2003-77, 2003-49 I.R.B. 1182.

SECTION 2. BACKGROUND

.01 On November 19, 2003, the Internal Revenue Service and Treasury Department filed with the Federal Register proposed and temporary regulations under § 461(f). 68 Fed. Reg. 65634, 65645; 2003-49 I.R.B. 1175, 1191. These regulations clarify that the transfer of a taxpayer's note or promise to provide property or services in the future is not a transfer for the satisfaction of a contested liability under § 461(f). The regulations also provide that a transfer of a taxpayer's stock or the stock or note of a related party is not a transfer for the satisfaction of a contested liability under § 461(f). The regulations further provide that, in general, economic performance does not occur when a taxpayer transfers money or other property to a trust, escrow account, or court to provide for the satisfaction of a contested workers compensation, tort, or other payment liability. Rather, economic performance occurs when payment is made to the claimant.

.02 Notice 2003-77, 2003-49 I.R.B. 1182, identifies as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations, transactions in which taxpayers established trusts purported to qualify under § 461(f) that are the same as or substantially similar to the following transactions:

(1) Transactions in which a taxpayer transfers money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954, and retains certain powers over the money or other property transferred;

(2) Transactions in which a taxpayer transfers any indebtedness of the taxpayer or any promise by the taxpayer to provide services or property in the future in taxable years beginning after December 31, 1953, and ending after August 16, 1954;

(3) Transactions in which a taxpayer using an accrual method of accounting transfers money or other property after July 18, 1984, to provide for the satisfaction of a workers compensation or tort liability (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant);

(4) Transactions in which a taxpayer using an accrual method of accounting transfers money or other property in taxable years beginning after December 31, 1991, to provide for the satisfaction of a liability for which payment is economic performance under ' 1.461-4(g) (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), other than a liability for workers compensation or tort; and

(5) Transactions in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in ' 267(b)), on

or after November 19, 2003.

.03 Section 1.6011-4(a) provides that every taxpayer that has participated (as described in § 1.6011-4(c)(3)) in a reportable transaction and that is required to file a tax return must attach a disclosure statement to its return. A reportable transaction includes any transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction. Section 1.6011-4(b)(2). Generally, a listed transaction is not treated as a reportable transaction if the transaction affected the taxpayer's Federal income tax liability as reported on any tax return filed on or before February 28, 2000. Section 1.6011-4T(b)(2) as published in T.D. 8877 in 65 Fed. Reg. 11205. See also § 1.6011-4(h).

.04 Sections 446(e) and 1.446-1(e) provide that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(i) provides that, to obtain the Commissioner's consent to an accounting method change, a taxpayer must file a Form 3115, Application for Change in Accounting Method, during the taxable year in which the taxpayer desires to make the proposed change. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with ' 446(e).

.05 Rev. Proc. 97-27, 1997-1 C.B. 680, (as modified and amplified by Rev. Proc.

2002-19, 2002-1 C.B. 696, as amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432), provides procedures for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. In general, under these procedures a taxpayer must file a Form 3115 during the year of change and may not request or make a retroactive change in method of accounting unless specifically authorized by the Commissioner. Rev. Proc. 97-27, sections 5.01, 2.04. In addition, under these procedures a taxpayer generally takes into account a positive § 481(a) adjustment resulting from the change in method of accounting ratably over four taxable years and receives audit protection for taxable years prior to the year of change. Rev. Proc. 97-27, sections 5.02(3)(a), 9.01. However, section 8.01 of Rev. Proc. 97-27 states that the Service reserves the right to decline to process a Form 3115 "in situations in which it would not be in the best interest of sound tax administration to permit the requested change. In this regard, the Service will consider whether the change in method of accounting would clearly and directly frustrate compliance efforts of the Service in administering the income tax laws."

.06 Rev. Rul. 90-38, 1990-1 C.B. 57, provides that, if a taxpayer uses an erroneous method of accounting for two or more consecutive taxable years, the taxpayer has adopted a method of accounting. The ruling further provides that a taxpayer may not, without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing an amended return.

.07 A change from deducting an asserted liability in the taxable year of transfer of money or other property to a trust described in Notice 2003-77 to deducting the liability in the taxable year of payment to the claimant is a change in method of accounting. The Service has determined that it is not in the best interest of sound tax administration to permit a prospective change in method of accounting for such deductions in transactions that are required to be disclosed as listed transactions under § 1.6011-4. In addition, in the interest of sound tax administration, the Service has determined that the terms and conditions set forth in Rev. Proc. 97-27 should be modified for changes in methods of accounting for such deductions in transactions that are not required to be disclosed as listed transactions under § 1.6011-4.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers that desire to change a method of accounting for transactions described in section 2.02 of this revenue procedure.

SECTION 4. APPLICATION

.01 Change in method of accounting for transactions described in Notice 2003-77 that are required to be disclosed as listed transactions under § 1.6011-4. The Service will not process applications for changes in method of accounting filed for transactions within the scope of this revenue procedure that are required to be disclosed under § 1.6011-4. Taxpayers may change their method of accounting for these transactions by filing an amended return in accordance with section 4.04 of this revenue procedure.

.02 Change in method of accounting for transactions described in Notice 2003-77 that are not required to be disclosed as listed transactions under § 1.6011-4. Taxpayers that desire to change a method of accounting for transactions within the scope of this revenue procedure that are not required to be disclosed under § 1.6011-4 may change their method of accounting for these transactions by filing an amended return in accordance with section 4.04 of this revenue procedure or may request a change in method of accounting in accordance with the advance consent procedures of Rev. Proc. 97-27 with the following modifications:

(1) In lieu of the four year spread period for positive § 481(a) adjustments provided in section 5.02(3)(a) of Rev. Proc. 97-27, the taxpayer must take into account the entire amount of a positive § 481(a) adjustment in the taxable year of change; and

(2) The taxpayer must describe each transaction, explain in the Form 3115 why the transaction is not required to be disclosed under § 1.6011-4, and state the amount of § 481(a) adjustment for that transaction.

.03 Change in method of accounting by taxpayers that have engaged in multiple transactions described in Notice 2003-77, some of which are required to be disclosed as listed transactions under § 1.6011-4. A taxpayer changing its method of accounting for multiple transactions within the scope of this revenue procedure, some of which are required to be disclosed under § 1.6011-4 and some of which are not required to be disclosed under § 1.6011-4:

(1) May change its method of accounting for transactions that are not required to be disclosed under § 1.6011-4 in accordance with section 4.02 of this revenue procedure, but must take into account in computing the § 481(a) adjustment only amounts attributable to those transactions; and

(2) Must file amended returns in accordance with sections 4.01 and 4.04 of this revenue procedure to change its method of accounting for all transactions required to be disclosed under § 1.6011-4 prior to filing the Form 3115 for transactions not required to be disclosed.

.04 Change in method of accounting by filing amended return.

(1) In accordance with § 1.446-1(e)(3)(ii) and Rev. Rul. 90-38, consent is hereby granted for any taxpayer that has engaged in a transaction within the scope of this revenue procedure to file amended returns to retroactively change an impermissible method of accounting for amounts transferred to trusts purported to qualify under § 461(f) to a method that complies with § 461(f) and the regulations thereunder. This consent is granted only if the taxpayer files such amended returns for the first taxable year in which the taxpayer used the impermissible method of accounting for these transactions (or if the period of limitations has expired for such taxable year, for the first taxable year for which the period of limitations has not expired) and for each subsequent taxable year in which the taxpayer's use of the impermissible method of accounting for these transactions reduced the taxpayer's taxable income. If the period of limitations has expired for the first taxable year in which a taxpayer used the impermissible method of accounting for these

transactions and the taxpayer files amended returns pursuant to this consent, the amended return for the first taxable year for which the period of limitations has not expired must include the entire amount of the § 481(a) adjustment attributable to the change in accounting method.

(2) A taxpayer that complies with section 4.04(1) of this revenue procedure also may file amended returns for any taxable years in which the taxpayer's use of the impermissible method of accounting for these transactions increased its taxable income.

(3) Taxpayers filing amended returns under this revenue procedure must write "FILED UNDER REVENUE PROCEDURE 2004-31"at the top of the amended return. Taxpayers also must comply with the requirements of § 1.6011-4 including, but not limited to, attaching to the amended return any disclosure statements that may be required in accordance with § 1.6011-4(a) and (e).

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective on **(INSERT DATE OF RELEASE).**

DRAFTING INFORMATION

The principal author of this revenue procedure is Norma Rotunno of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Rotunno at (202) 622-7900 (not a toll-free number).

Part III - Administrative, Procedural, and Miscellaneous

Transfers to Trusts to Provide for the Satisfaction of Contested Liabilities

Notice 2003-77

The Internal Revenue Service and Treasury Department are aware of certain transactions that use contested liability trusts improperly to attempt to accelerate deductions for contested liabilities under ' 461(f) of the Internal Revenue Code. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of ' 1.6011-4(b)(2) of the Income Tax Regulations and ' ' 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

LAW

Section 461(f) provides an exception to the general rules of tax accounting by allowing a taxpayer to deduct a contested liability in a year prior to the resolution of the contest if the following conditions are satisfied: (1) the taxpayer contests an asserted liability; (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability; (3) the contest with respect to the asserted liability exists after the time of transfer; and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after the application of the economic performance rules. If these requirements are satisfied, a taxpayer may deduct the liability in the taxable year of the transfer.

On November 19, 2003, the Service and Treasury Department filed with the Federal Register proposed and temporary regulations under ' 461(f). Section 1.461-2T(c)(1) of these temporary regulations, which replaces and restates ' 1.461-2(c)(1), provides that a transfer for the satisfaction of an asserted liability is a transfer of money or property beyond the taxpayer=s control to: (1) the person asserting the liability; (2) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) providing that the money or other property be delivered in accordance with the settlement of the contest; (3) an escrowee or trustee pursuant to an order of a court or government entity providing that the money or other property be delivered in accordance with the settlement of the contest; or (4) a court with jurisdiction over the contest. An account is in the taxpayer=s control unless the taxpayer has relinquished all authority over the money or other property transferred.

Section 1.461-2T(c)(1)(iii) provides that the following actions are not transfers to provide for the satisfaction of an asserted liability: (1) the purchase of a bond to guarantee payment of the asserted liability; (2) an entry on the taxpayer=s books of account; and (3) a transfer to an account in the taxpayer=s control. The temporary regulations clarify that a transfer in taxable years beginning after December 31, 1953, and ending after August 16, 1954, of any indebtedness of a taxpayer or any promise by the taxpayer to provide services or property in the future is not a transfer to provide for the satisfaction of an asserted liability. In addition, the temporary regulations provide the express rule that a transfer (other than to the person asserting the liability) of a taxpayer=s stock, or the indebtedness or stock of a person related to the taxpayer (as defined in section 267(b)), is not a transfer to provide for the satisfaction of an asserted liability.

Section 461(h)(2)(C) provides that, if a workers compensation or tort liability requires a payment to another person, then economic performance occurs as payments to the person are made. The Conference Report accompanying enactment of ' 461(h) states:

> In the case of workers= compensation or tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as payments are made to that person. Since payment to a section 461(f) trust is not a payment to the claimant and does not discharge the taxpayer=s liability to the claimant, such payment does not satisfy the economic performance test.

H.R. Rep. No. 861, 98th Cong., 2d Sess. 871, 876 (1984).

Section 461(h)(2)(D) provides that in the case of other liabilities, economic performance occurs at the time determined under regulations prescribed by the Secretary. Section 1.461-4(g)(2) through (7) describes other liabilities for which payment is economic performance.

Section 1.461-4(g)(1)(ii)(A) provides that payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer.

Section 1.461-4(g)(1)(i) provides that, for certain liabilities for which payment is economic performance, economic performance does not occur as a taxpayer makes payments in connection with the liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed. In *Maxus Energy*

Corporation and Subsidiaries v. United States, 31 F.3d 1135, 1144, 1145 (Fed. Cir. 1994), the taxpayer=s payment to a settlement fund effectively constituted payment to the person to which the liability was owed because the claimants agreed to look solely to the fund to satisfy their claims and, therefore, the taxpayer=s payment to the fund discharged its liability to the claimant.

Section 1.461-2T(e)(2) provides that, except as provided in ' 468B or the regulations thereunder, economic performance does not occur when a taxpayer transfers money or other property to a trust, escrow account, or court to provide for the satisfaction of a contested workers compensation, tort, or other liability designated in ' 1.461-4(g) unless the trust, escrow account, or court is the claimant or the taxpayer=s payment to the trust, escrow account, or court discharges the taxpayer=s liability to the claimant.

ANALYSIS

The Service and Treasury Department have become aware of transactions in which taxpayers have established trusts purported to qualify under ' 461(f), but that fail to comply with the requirements of ' 461(f) or the regulations by reason of: (1) retention of powers over the trust assets (such as the power to substitute assets, to pay the contested liabilities out of assets other than those in the trust, or to limit the trustee=s ability to sell the taxpayer=s assets that the taxpayer transferred to the trust), contrary to the requirement that the taxpayer relinquish control over the property transferred; (2) transfer to the trust of related party notes under circumstances indicating the liability is not genuine or that there is no intent between the parties to enforce the obligation, which is not a valid transfer to provide for the satisfaction of an asserted liability; or (3) establishment of trusts for contested tort, workers compensation, or other liabilities designated in ' 1.461-4(g), for which economic performance requires payment to the claimant.

Transactions that are the same as, or substantially similar to, the following transactions are identified as Alisted transactions@ for purposes of ' ' 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2):

(1) transactions in which a taxpayer transfers money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954, to a trust purported to be established under ' 461(f) to provide for the satisfaction of an asserted liability and retains any one or more of the following powers over the money or other property transferred: to pay any liabilities ultimately due to the claimant out of assets other than those transferred to the trust; to substitute money or other property for property transferred to the trust; to prohibit payment to the claimant by the trustee until instructed by the taxpayer; to prohibit notification to the claimant of the trust=s establishment; to limit the trustee=s ability to sell the property after it is transferred to the trust; and to limit the trustee=s ability to enforce notes or rights relating to other property transferred to the trust;

(2) transactions in which a taxpayer transfers any indebtedness of the taxpayer or any promise by the taxpayer to provide services or property in the future in taxable years beginning after December 31, 1953, and ending after August 16, 1954, to a trust purported to be established under ' 461(f) to provide for the satisfaction of an asserted liability;

(3) transactions in which a taxpayer using an accrual method of accounting transfers money or other property after July 18, 1984, to a trust purported to be established under ' 461(f) to provide for the satisfaction of a workers compensation or tort liability (unless the trust is the person to which the liability is owed, or payment to the trust discharges the

taxpayer's liability to the claimant);

(4) transactions in which a taxpayer using an accrual method of accounting transfers money or other property in taxable years beginning after December 31, 1991, to a trust purported to be established under ' 461(f) to provide for the satisfaction of a liability for which payment is economic performance under ' 1.461-4(g) (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), other than a liability for workers compensation or tort; and

(5) transactions in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in ' 267(b)), on or after November 19, 2003, to a trust purported to be established under ' 461(f) to provide for the satisfaction of any asserted liability.

Independent of their classification as Alisted transactions,@ transactions that are the same as, or substantially similar to, the transactions described in this notice may already be subject to the disclosure requirements of ' 6011 (' 1.6011-4), the tax shelter registration requirements of ' 6111 ('' 301.6111-1T, 301.6111-2), or the list maintenance requirements of ' 6112 (' 301.6112-1). Persons required to register these tax shelters under ' 6111 who have failed to do so may be subject to the penalty under ' 6707(a). Persons required to maintain lists of investors under ' 6112 who have failed to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under ' 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under ' 6662.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective November 19, 2003, the date this notice is released to the public. The references to specific taxable years and dates in the description of transactions covered by this notice are intended to provide consistency with the temporary and proposed regulations under § 461(f) filed with the Federal Register on November 19, 2003. Only those transactions covered by the provisions (including the effective date provisions) of the disclosure, tax shelter registration, and list maintenance requirements under §§ 6011, 6111, and 6112 and the regulations thereunder will be subject to those requirements.

DRAFTING INFORMATION

The principal author of this notice is Norma Rotunno of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Rotunno at (202) 622-7900 (not a toll-free number).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1514

Treasury and IRS Issue Guidance On Capital Gain Dividends

The IRS and the Treasury Department today issued guidance to clarify that capital gain dividends received from a mutual fund in 2004 will be taxed at the new, lower capital gain rates enacted last year.

"Last year the President's Jobs and Growth Tax Relief Reconciliation Act of 2003 lowered the capital gains rates on dividends," said Acting Assistant secretary for Tax policy Greg Jenner. "These lower rates mean taxpayers will have more money to invest, save for their children's education or buy a home"

Mutual funds with net capital gains may designate some of their dividends as "capital gain dividends," which are taxed to the fund's shareholders like long term capital gains. Since 1997, mutual funds' designations of capital gain dividends have included an additional designation of which rate applies to the dividend because long term capital gains from different sources have been taxed at different tax rates.

Concern had been expressed that the existing rules for dividend designation and the transition to the new, lower capital gain rates enacted last year might cause some 2004 capital gain dividends to be taxed to fund shareholders at the old, higher capital gain rates. The guidance issued today clarifies that this will not occur.

-30-

REPORTS

- Notice 2004-39

Part III—Administrative, Procedural, and Miscellaneous

Capital Gain Dividends of RICs and REITs

Notice 2004–39

SECTION 1. PURPOSE

This notice provides guidance to regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and their shareholders in applying § 1(h) of the Internal Revenue Code to capital gain dividends of RICs and REITs. The notice explains how the changes to § 1(h) made by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "JGTRRA"), Pub. L. No. 108–27, 117 Stat. 752, apply to RIC and REIT capital gain dividends paid (or accounted for as if paid) in taxable years that end on or after May 6, 2003.

SEC. 2. BACKGROUND

For individuals, estates, and trusts, § 1(h) imposes differing rates of tax on various transactions depending on the types of transactions giving rise to net capital gains. For transactions taken into account during taxable years ending before May 6, 2003, a taxpayer's long-term capital gains and losses generally are separated into three tax-rate groups: a 20–percent group, a 25–percent group, and a 28–percent group. See Notice 97–59, 1997–2 C.B. 309. For certain taxpayers, transactions in the 20–percent group may be taxed at a 10–percent rate, or at an 8–percent rate if the gain is qualified 5–year gain under § 1(h)(9) (as in effect before the enactment of the JGTRRA).

For transactions taken into account during taxable years ending on or after May 6, 2003, and beginning before January 1, 2009, the JGTRRA reduced the 20–percent rate to 15 percent, reduced the 10–percent rate to 5 percent (0 percent for taxable years beginning after 2007), and repealed the rules dealing with qualified 5–year gain. For a taxable year that includes May 6, 2003, the reduction in rates and the repeal of the rules dealing with qualified 5–year gain apply to gain or loss properly taken into account for the portion of the taxable year on or after May 6, 2003. Because this effective date generally occurs sometime during a taxpayer's taxable year, the amount of capital gain that benefits from the reduced 15–percent (or 5–percent) rate is generally the lesser of the net capital gain for the entire taxable year or the net capital gain determined using only gain and loss properly taken into account for the portion of the taxable year on or after May 6, 2003. JGTRRA § 301(c)(1)–(2) ("the JGTRRA transition rule"). In applying the JGTRRA transition rule with respect to a pass-through entity, the determination of when gains and losses are properly taken into account is made at the entity level. Id. § 301(c)(4). See the last paragraph of Section 3 of this notice for the application of this rule.

The Secretary has authority to issue regulations concerning the application of § 1(h) to sales and exchanges by (and of interests in) pass-through entities, including RICs and REITs. § 1(h)(9).

To the extent that a RIC or a REIT has net capital gain for a taxable year, it may designate as capital gain dividends the dividends that it pays during the year, the dividends that § 855 or 858 deems it to pay during the year, or deficiency dividends under § 860 that it pays for that year. In general, a capital gain dividend is treated by the shareholders that receive it as a gain from the sale or exchange of a capital asset held for more than one year.

Notice 97–64, 1997–2 C.B. 323, describes regulations that will be issued under § 1(h) concerning the application of § 1(h) to capital gain dividends of RICs and REITs, effective for taxable years ending on or after May 7, 1997. As described in Notice 97–64, the regulations will allow a RIC or REIT to make additional designations of capital gain dividends to reflect the differing tax-rate groups under § 1(h) and will provide limitations on the amounts that can be designated in the differing tax-rate groups. In calculating those limitations, the regulations will provide for a deferral adjustment or bifurcation adjustment in certain situations. In addition, the regulations will provide special rules for distributions of § 1202 gain.

Moreover, when those regulations are issued, they will reflect changes to § 1(h) since the publication of Notice 97–64. (For example, the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105–277, 112 Stat. 2681–886, ended the relevance of holding a capital asset for more than 18 months.)

This Notice 2004–XX describes how the reduction in rates made by the JGTRRA and the JGTRRA transition rule (for taxable years that include May 6, 2003), apply to capital gain dividends of RICs and REITs. Future guidance may be issued to clarify certain of the rules originally described in Notice 97–64 and to make other modifications to take into account industry experience with the rules. That guidance generally will apply on a prospective basis.

SEC. 3 APPLICATION OF § 1(h) TO RIC AND REIT CAPITAL GAIN DIVIDENDS

For taxable years ending on or after May 6, 2003, the rules described in Notice 97–64 continue to apply to capital gain dividends of RICs and REITs, with appropriate modifications to take into account the changes that have been made to § 1(h) since that notice was published. Thus, if a RIC or REIT designates a dividend as a capital gain dividend, the RIC or REIT may make an additional designation of the dividend as a 15%–rate gain distribution, subject to the limitations described in section 5 of Notice 97–64, including the limitation that the additional designation of a class of capital gain dividend not exceed the maximum distributable amount in that class.

In general, a RIC or REIT determines the maximum distributable amounts that may be designated in each class of capital gains dividends by performing the computation required by § 1(h) as if the RIC or REIT were an individual whose ordinary income is subject to a marginal tax rate of at least 28 percent. The maximum distributable gain in each class of capital gain dividends is equal to the amount that, in the computation under § 1(h), is multiplied by the corresponding rate gain percentage. The computation under § 1(h), however, is modified in the following ways:

- The RIC or REIT disregards qualified dividend income. That is, net capital gain is not increased by qualified dividend income, and qualified dividend income is disregarded in determining the amount of gain properly taken into account for the portion of a taxable year on or after May 6, 2003. (Under § 854(b) or § 857(c), qualified dividend income received by the RIC or REIT may contribute to a separate designation of other RIC or REIT dividends.)
- The RIC or REIT makes the deferral adjustment or bifurcation adjustment described in section 6 of Notice 97–64.
- The computation takes into account, if applicable, the JGTRRA transition rule for taxable years that contain May 6, 2003. The JGTRRA transition rule, however, interacts with the deferral adjustment in a way that differs from the interaction between that adjustment and the transition rule for the 1997 reductions in capital gains rates. That is, for purposes of the JGTRRA transition rule, the deferral adjustment is applied in determining whether a gain or loss is taken into account before May 6, 2003, or after May 5, 2003. For example, if a RIC sells shares of stock before May 6, 2003, but the sale is treated under § 852(b)(3)(C) and § 1.852–11(e) as arising after that date, the sale is taken into account on the later date for purposes of the JGTRRA transition rule. This application of the deferral adjustment differs from the special rule in section 6 of Notice 97–64 for transactions occurring during 1997.

The JGTRRA transition rule applies at both the RIC/REIT level and at the shareholder level. That is, the rule applies at the RIC/REIT level to taxable years of the RIC or REIT that contain May 6, 2003, to govern how capital gain dividends may be designated, and it applies to taxable years of RIC/REIT shareholders that contain May 6, 2003, to govern the application of § 1(h) to the shareholder for that taxable year. Thus, if a RIC or REIT pays a capital gain dividend during 2004 that it properly designates as a 20%–rate gain distribution and the dividend is received by a fiscal year trust in a year of the trust that includes May 6, 2003, the dividend is treated by the trust as gain that is properly taken into account for the portion of the taxable year before May 6, 2003. On the other hand, if that same capital gain dividend is received during 2004 by an individual shareholder, or a trust, whose taxable year is the calendar year, the dividend is subject to tax at a rate no higher than 15 percent, because the JGTRRA transition rule applies only to shareholder taxable years that include May 6, 2003.

In taxable years beginning on or after May 6, 2003, some taxpayers may receive a RIC or REIT distribution amount that is designated as a 20%–rate gain distribution and that includes a portion constituting 5–year gain. As a result of the repeal of the separate rules for 5-year gains, the 5–year gain portion of that 20%–rate gain distribution is not subject to the prior-law 8–percent rate for 5–year gain. These taxpayers, however, will not be disadvantaged by the rate changes. The 5–year gain portion will be treated the same as any other 20%–rate gain distribution that is received in a taxable year beginning on or after May 6, 2003, and therefore will be taxed at a rate no higher than 15 percent (5 percent for certain taxpayers). Any taxpayer that would have been eligible in a taxable year to pay tax at the 8–percent rate for some or all 5–year gain had the prior rates remained in effect will be eligible under the new rules to pay tax on that amount of 5–year gain at the 5–percent rate.

SEC. 4 EXAMPLES

(1) Example 1. RIC X's taxable year ends on April 30. X has only the following capital gains and losses for the periods indicated, all of which are from sales of stock held for less than five years:

	GAIN	LOSS	NET
5/1 to 5/5/2003			
Long-term capital gain or loss	100x	0	100x
Short-term capital gain or loss	100x	0	100x
5/6 to 10/31/2003			
Long-term capital gain or loss	0	0	0
Short-term capital gain or loss	0	(90x)	(90x)
11/1 to 4/30/2004			
Long-term capital gain or loss	110x	0	110x
Short-term capital gain or loss	0	0	0

X does not make a deferral adjustment because X does not have a post-October net capital loss or net long-term capital loss for its taxable year ending April 30, 2004. X must make a bifurcation adjustment, however, because it has a pre-November net capital gain, it has a taxable year ending in April, and it does not make a deferral adjustment. Because X must apply both the bifurcation adjustment and the JGTRRA transition rule, for the pre-November and post-October portions of this taxable year X must make separate determinations of the maximum amounts that may be designated as 20%–rate gain and 15%–rate gain. The sum of these amounts determines the various maximum amounts that can be designated in the different classes of gain for the entire year.

For the pre-November period, the JGTRRA transition rule applies because the period includes May 6, 2003. Thus, X determines a net capital gain amount using only gain and loss properly taken into account for the portion of the taxable year that is on or after May 6, 2003 (and, because the determination is for the pre-November period, on or before October 31, 2003). The amount so determined is $0. X's net capital gain for the entire pre-November period is $100x. Thus, for the pre-November period, X's maximum designation of 20%–rate gain is $100x and its maximum designation of 15%–rate gain is $0. (X also has a net short-term gain of $10x in the pre-November period, which results in a dividend that is not specially designated and is treated by shareholders as ordinary income.)

For the post-October period, the JGTRRA transition rule does not apply because that period does not include May 6, 2003. Because X has $110x of net capital gain for that period, X's maximum designation of 15%–rate gain is $110x.

For the taxable year ending April 30, 2004, therefore, X may designate up to $210x of capital gain dividends, of which up to $110x may be designated as 15%–rate gain distributions and up to $100x may be designated as 20%–rate gain distributions.

(2) Example 2. RIC Y's taxable year ends on April 30. Y has only the following capital gains and losses for the periods indicated, all of which are from sales of stock held for less than five years:

	GAIN	LOSS	NET
5/1 to 5/5/2003			
Long-term capital gain or loss	90x	0	90x
Short-term capital gain or loss	0	0	0
5/6 to 10/31/2003			
Long-term capital gain or loss	0	(90x)	(90x)
Short-term capital gain or loss	0	0	0
11/1 to 4/30/2004			
Long-term capital gain or loss	100x	0	100x
Short-term capital gain or loss	0	0	0

Y does not make a deferral adjustment because it does not have a post-October net capital loss or net long-term capital loss for its taxable year ending April 30, 2004. Y does not make a bifurcation adjustment because it does not have a net capital gain for the pre-November portion of its taxable year ending April 30, 2004. Because Y's taxable year ending April 30, 2004, includes May 6, 2003, the JGTRRA transition rule applies in determining Y's maximum designations of capital gain for that taxable year.

Y's net capital gain for the entire year is $100x. Y's net capital gain determined using only gain and loss properly taken into account for the portion of the taxable year on or after May 6, 2003, however, is $10x. For this taxable year, Y may designate up to $100x of capital gain dividends, of which up to $10x may be designated as 15%–rate gain distributions and up to $90x may be designated as 20%–rate gain distributions.

Assume that Y pays a capital gain dividend on December 1, 2004, and that, under § 855(a), Y treats the dividend as having been paid during its taxable year ending April 30, 2004, but that, under § 855(b), Y's shareholders treat the dividend as having been received in their taxable years that contain December 1, 2004. Assume also that shareholder A of Y is an individual, estate, or trust whose taxable year is the calendar year and that, on December 1, 2004, A receives from Y a dividend of $10x, of which $1x is designated as a 15%–rate gain distribution and $9x is designated as a 20%–rate gain distribution. Because A's 2004 taxable year does not include May 6, 2003, neither the JGTRRA transition rule nor JGTRRA § 301(c)(4) applies to A for that taxable year. Thus, the $10x capital gain dividend received by A in 2004 is subject to a tax rate no higher than 15 percent.

DRAFTING INFORMATION

The principal author of this notice is Sonja Kotlica of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Ms. Kotlica on (202) 622-3960 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1515

Treasury and IRS Issue Guidance on Interest Deductions and Tax-Exempt Interest Income

Today, the Treasury Department and the IRS released guidance regarding the disallowance of deductions for interest paid on funds borrowed to purchase or carry tax-exempt obligations.

The guidance issued today addresses questions that have arisen regarding interest deductions by a borrower that lends or contributes money to a related entity that is a dealer in tax-exempt obligations. The guidance also clarifies the interaction between the adjustments required under the interest disallowance rules and certain adjustments required under the consolidated return regulations. In addition, the Treasury Department and the IRS requested comments regarding the application of the interest deduction disallowance rules in other situations in which a party related to the borrower invests in tax-exempt obligations or an intermediary comes between the borrower and a dealer in tax-exempt obligations.

"The guidance issued today answers several significant questions," said Acting Assistant Secretary for Tax Policy Gregory Jenner. "The comments requested will help the IRS and the Treasury Department to provide additional guidance on related issues."

-30-

REPORTS

- Revenue Ruling 2004-47
- Reg. 128572-03
- Reg. 128590-03

Part I

Section 265(a)(2).—Expenses and interest relating to tax-exempt income

26 CFR 1.265-2: Interest relating to tax-exempt income.

Rev. Rul. 2004-47

ISSUE

If a member of an affiliated group borrows money and transfers the money to another member of the group that is a dealer in tax-exempt obligations, does ' 265(a)(2) of the Internal Revenue Code apply to disallow the interest expense of the borrowing corporation?

FACTS

Situation 1. - P and S are corporations that are members of the same affiliated group, but file separate tax returns. P and S use the calendar year as their taxable year. S is a dealer in tax-exempt obligations, whose general business includes purchasing and carrying tax-exempt securities.

On January 1, 2004, L, a bank unrelated to the affiliated group that includes P and S, lends $40x to P for 5 years. L=s loan to P provides for payments of interest on December 31 of each year at a rate higher than the appropriate applicable Federal rate. P contributes the $40x borrowed from L to the capital of S, and S uses the contributed funds in its business. Although the borrowed funds are directly traceable from P to S, they are not directly traceable to the purchase or carry of specific tax-exempt obligations by S. During its taxable year 2004, S holds an average of $500x of tax-exempt obligations (valued at their adjusted bases), and an average of $1,000x of total assets (valued at their adjusted bases). During its taxable year 2004, P holds an average of $10,000x of total assets (valued at their adjusted bases) and no tax-exempt obligations in the active conduct of its trade or business, and incurs $2x of interest expense on its $40x loan from L.

Situation 2. - The facts are the same as in *Situation 1*, except that P and S file a consolidated return.

Situation 3. - The facts are the same as in *Situation 1*, except that the funds that P borrowed from L are not directly traceable to any funds transferred from P to S and there is no other direct evidence linking the borrowed funds to any funds transferred from P to S.

Situation 4. - The facts are the same as in *Situation 1*, except that P loans to S the $40x borrowed from L on the same terms and conditions as the loan from L to P. During its taxable year 2004, S incurs $2x of interest expense on its $40x loan from P.

LAW AND ANALYSIS

In general, a deduction is allowed under ' 163 of the Code for all interest paid or accrued on indebtedness. Under ' 265(a)(2), however, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes.

Rev. Proc. 72-18, 1972-1 C.B. 740, sets forth guidelines for the application of ' 265(a)(2). Section 3.01, which applies to all taxpayers, states that the application of

' 265(a)(2) requires a determination of the taxpayer=s purpose in incurring or continuing each item of indebtedness, based on all the facts and circumstances. That section further states that the taxpayer's purpose may be established by either direct or circumstantial evidence.

Section 3.02 of Rev. Proc. 72-18 provides that direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations. Wynn v. United States, 411 F.2d 614 (3d Cir. 1969), cert. denied, 396 U.S. 1008 (1970). Section 265(a)(2) does not apply, however, when proceeds of a bona fide business indebtedness are temporarily invested in tax-exempt obligations under circumstances similar to those set forth in Rev. Rul. 55-389, 1955-1 C.B. 276.

Section 3.03 of Rev. Proc. 72-18 provides that direct evidence of a purpose to carry tax-exempt obligations exists when tax-exempt obligations are used as collateral for indebtedness. "[One] who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) [the predecessor of ' 265(a)(2)] makes no distinction between them." Wisconsin Cheeseman v. United States, 388 F.2d 420 (7th Cir. 1968), at 422. Section 3.04 of Rev. Proc. 72-18 states that in the absence of direct evidence linking indebtedness with the purchase or carrying of tax-exempt obligations as illustrated in paragraphs 3.02 and 3.03 of Rev. Proc. 72-18, section 265(a)(2) of the Code will apply only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. Stated alternatively, section 265(a)(2) will apply only when the totality of facts and circumstances establishes a "sufficiently direct relationship" between the borrowing and the investment in tax-exempt obligations. See Wisconsin Cheeseman, 388 F.2d at 422. The guidelines set forth in sections 4, 5, and 6 of Rev. Proc. 72-18 are used to determine whether such a relationship exists.

Section 3.05 of Rev. Proc. 72-18 provides that generally, when a taxpayer=s investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will ordinarily not be inferred in the absence of direct evidence as set forth in sections 3.02 and 3.03 of that revenue procedure. Section 3.05 provides further that in the case of a corporation, an investment in tax-exempt obligations shall be presumed insubstantial only when during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted bases) does not exceed 2 percent of the average total assets (valued at their adjusted bases) held in the active conduct of the trade or business. The de minimis rule of paragraph 3.05 does not apply to dealers in tax-exempt obligations.

Section 5 of Rev. Proc. 72-18 provides special rules for dealers in tax-exempt obligations. Specifically, section 5.03 states that if debt is incurred or continued for the general purpose of carrying on a brokerage business that includes the purchase of both taxable and tax-exempt obligations, and the use of the borrowed funds cannot be directly traced, it is reasonable to infer that the borrowed funds were used for all the activities of the business, including the purchase of tax-exempt obligations. Section 5 of Rev. Proc. 72-18 refers to a specific allocation formula in section 7 of Rev. Proc. 72-18, derived from the formula in Commissioner v. Leslie, 413 F.2d 636 (2d. Cir.1969), cert. denied, 396 U.S. 1007 (1970). The formula is applied to interest on borrowed funds that are not directly traceable to tax-exempt obligations. The formula consists of a fraction, whose numerator is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted bases), and whose denominator is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted bases) minus the amount of any indebtedness the interest on which is not subject to disallowance to any extent under Rev. Proc. 72-18.

In H Enterprises International v. Commissioner, 75 T.C.M. 1948 (1998), aff=d, 183 F.3d 907 (8th Cir. 1999), a parent and a subsidiary were members of the same consolidated group of corporations. The subsidiary declared a dividend and, a few days later, borrowed funds and immediately used part of those funds to make the dividend distribution to the parent. A portion of the distributed funds was disbursed to two investment divisions of the parent, which used the funds to acquire investments including tax-exempt obligations.

The court held that a portion of the subsidiary=s indebtedness was incurred for the purpose of purchasing or carrying tax-exempt obligations (held in the parent=s investment divisions) and, therefore, no deduction was allowed for the interest on this portion of the indebtedness under ' 265(a)(2). To establish the required purposive connection under ' 265(a)(2), the court reasoned that the activities of the parent corporation were relevant in determining the subsidiary's purpose for borrowing the funds. If the analysis only focused on the borrower and not the transferee, then the purpose of the borrower corporation would always be acceptable, frustrating the legislative intent of ' 265(a)(2).

In both *Situations 1* and *2*, following the rationale of H Enterprises, the activities of S must be taken into account to determine P=s purpose under ' 265(a)(2) for borrowing the $40x of funds that are directly traceable to P's contribution to the capital of S. In order to determine the activities of S, however, Rev. Proc. 72-18 must be applied. Because S=s brokerage business includes the purchase of both taxable and tax-exempt obligations, it is reasonable to infer under section 5.03 of Rev. Proc. 72-18 that part of P=s debt was incurred for the purpose of purchasing or carrying tax-exempt obligations. Applying the allocation formula in section 7 of Rev. Proc. 72-18, the interest expense incurred by P on the $40x borrowed is subject to partial disallowance. The ratio of S=s average tax-exempt obligations to S=s total assets is $500x/$1,000x. Therefore, one-half of the $2x interest expense incurred by P (i.e., $1x) is disallowed as a deduction to P under ' 265(a)(2). P is not entitled to the 2 percent de minimis rule provided by section 3.05 of Rev. Proc. 72-18 because S is a dealer in tax-exempt obligations.

In *Situation 3*, there is no direct evidence that P transferred to S any portion of the $40X P borrowed from L. Without such direct evidence, the activities of S will not be taken into account to determine P=s purpose under ' 265(a)(2) for borrowing the $40x and it is not reasonable to infer that part of P=s debt was incurred for the purpose of purchasing or carrying tax-exempt obligations. Therefore, none of the $2x interest expense incurred by P is disallowed as a deduction under ' 265(a)(2).

In *Situation 4*, the $40x that P borrowed from L is directly traceable to P's loan to S. Accordingly, the two separate back-to-back loans (i.e., the loan from L to P, followed by the loan from P to S) must each be examined for the potential application of ' 265(a)(2). With regard to the loan from L to P, P uses the borrowed funds to make a loan to S, and separately accounts for the taxable interest income from this loan. P does not have a purpose of using the borrowed funds to purchase or carry tax- exempt obligations within the meaning of ' 265(a)(2). With regard to the loan from P to S, although the borrowed funds are not directly traceable to S=s purchase or carry of tax-exempt obligations, ' 265(a)(2) applies to S, a dealer in tax-exempt obligations, to disallow a portion of its interest expense. The portion of S=s interest deduction that is disallowed is computed by applying the allocation formula in section 7 of Rev. Proc. 72-18. The ratio of S=s average tax-exempt obligations to S=s total assets is $500x/$1,000x. Accordingly, one-half of the $2x interest expense incurred by S (i.e., $1x) is disallowed to S as a deduction under ' 265(a)(2). S is not entitled to the 2 percent de minimis rule provided by section 3.05 of Rev. Proc. 72-18 because S is a dealer in tax-exempt obligations.

HOLDINGS

If a member of an affiliated group borrows money and contributes the borrowed funds to another member that is a dealer in tax-exempt obligations such that the funds contributed to the dealer are directly traceable to the contributor=s borrowing, but are not directly traceable to the dealer=s purchase or carry of tax-exempt obligations, ' 265(a)(2) applies to disallow a portion of the interest expense of the contributor. The portion of the contributor=s interest deduction to be disallowed is determined by applying the allocation formula in section 7 of Rev. Proc. 72-18 to the dealer that uses the borrowed funds in its business.

If a member of an affiliated group borrows money and there is no direct evidence linking the borrowed funds to any funds transferred to another member who is a dealer in tax-exempt obligations, ' 265(a)(2) does not apply to disallow any portion of the interest expense of the borrowing member based on the dealer member's investment in tax-exempt obligations.

If the funds borrowed by a member of an affiliated group are directly traceable to a loan to another member that is a dealer in tax-exempt obligations, ' 265(a)(2) does not apply to disallow the interest expense of the lending member, but does apply to disallow a portion of the interest expense of the dealer. The portion of the dealer=s interest deduction to be disallowed is determined by applying the allocation formula in section 7 of Rev. Proc. 72-18.

DRAFTING INFORMATION

The principal authors of this revenue ruling are David B. Silber and Avital Grunhaus of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Mr. Silber or Ms. Grunhaus at (202) 622-3930 (not a toll-free call).

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-128572-03]

RIN 1545-BC24

Application of sections 265(a)(2) and 246A in Multi-Party Financing Arrangements; Request for Comments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The IRS and Treasury Department are soliciting comments and suggestions regarding the scope and details of regulations that may be proposed under section 7701(f) of the Internal Revenue Code to address the application of sections 265(a)(2) and 246A in transactions involving related parties, pass-through entities, or other intermediaries.

DATES: Written or electronic comments must be submitted by August 5, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-128572-03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-128572-03), 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 or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-128572-03).

FOR FURTHER INFORMATION CONTACT: Concerning submissions, LaNita Van Dyke, (202) 622-7180; concerning the notice, Avital Grunhaus, (202) 622-3930 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 163(a) generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. Section 265(a)(2), however, provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes.

Generally, section 246A reduces the dividends received deduction under section 243, 244, or 245(a) to the extent that the portfolio stock, with respect to which the dividends are received, is debt-financed. Stock is treated as debt-financed if there is indebtedness directly attributable to the stock investment.

Section 7701(f) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the provisions of the Internal Revenue Code that deal with (1) the linking of borrowing to investment, or (2) diminishing risk, through the use of related persons, pass-thru entities, or other intermediaries.

Concurrent with the publication of this advance notice of proposed rulemaking in the **Federal Register**, the IRS and Treasury are issuing Rev. Rul. 2004-47 (2004-21 I.R.B.), which provides guidance on the application of section 265(a)(2) to disallow a portion of interest incurred by one member of an affiliated group when it transfers borrowed funds to another member of the group that is a dealer in tax-exempt bonds. In the circumstances described in *Situations 1* and *2* of that ruling, the funds borrowed by one member are directly traceable to the funds the borrowing member transfers to the dealer member. Under Rev. Proc. 72-18 (1972-1 C.B. 740), the application of section 265(a)(2) to these facts requires a determination of the borrowing member's purpose for incurring or continuing each item of indebtedness. The revenue ruling holds that the purpose of the borrowing member is determined by reference to the use of the borrowed funds in the business of the dealer member to whom the funds are made available. This conclusion is based on H Enterprises International v. Commissioner, 75 T.C.M. 1948 (1998), aff=d per curiam, 183 F.3d 907 (8th Cir. 1999). The result is a disallowance of the borrowing member=s interest expense under section 265(a)(2).

In H Enterprises, a parent and a subsidiary were members of the same consolidated group of corporations. The subsidiary declared a dividend and, a few days later, borrowed funds and immediately used part of those funds to make the dividend distribution to the parent. A portion of the distributed funds was disbursed to two investment divisions of the parent, which used the funds to acquire investments including tax-exempt obligations and corporate stock. The court held that a portion of the indebtedness was incurred to purchase and carry tax-exempt obligations for the purpose of section 265(a)(2) and that a portion of the indebtedness was directly attributable to the purchase and carry of portfolio stock for the purpose of section 246A.

The transactions described in *Situations 1* and *2* of Rev. Rul. 2004-47 and the transaction before the court in H Enterprises all involve funds borrowed by one member of an affiliated group that can be directly traced to funds transferred to another member of the group.

In contrast to the transactions described in *Situations 1* and *2*, in the transaction described in *Situation 3* of Rev. Rul. 2004-47, the borrowed funds are not directly traceable to the funds transferred to the dealer member, and there is no other direct evidence linking the borrowed funds to the funds transferred to the dealer member. The revenue ruling holds that in these circumstances, section 265(a)(2) will not be applied to disallow interest expense of the borrowing member.

Other situations may not be so clear. For example, funds may be transferred among the members of an affiliated or consolidated return group in a variety of ways that make it difficult to match borrowed funds with particular investments or other uses. Furthermore, certain taxpayers may affirmatively seek to avoid application of the rules of sections 265(a)(2) and 246A by using related parties, pass-thru entities, or other intermediaries in a manner that obscures the linkage between borrowing outside of the affiliated group and the purchase or carry of investments within the group.

During the course of developing Rev. Rul. 2004-47, the IRS and Treasury began preliminary consideration of possible regulations that might be adopted under the authority granted by section 7701(f) to provide clearer rules for matching borrowings and investments and for administering more effectively the purposes of section 265(a)(2). For example, Treasury and IRS are considering a rule that would permit taxpayers to trace proceeds of borrowings to specific taxable investments or other specific uses but would apply a pro rata approach to determine the use of proceeds of borrowings that are not traceable to a specific use. This would differ from a general rule requiring a pro rata allocation of borrowings among all available uses, such as the rule in section 265(b) applicable to financial institutions.

The IRS and Treasury also are considering whether to adopt regulations under section 7701(f) for purposes of section 246A (dealing with debt financing of portfolio stock).

The IRS and Treasury are requesting comments on whether regulations should be adopted under section 7701(f) for purposes of applying section 265(a)(2) or section 246A and, if so, the approach that should be taken in such regulations. Specifically, the IRS and Treasury are inviting comments on the approach of supplementing a specific tracing rule with a pro rata allocation rule, as well as suggestions for alternative approaches. Comments addressing the possible adoption of regulations for purposes of section 246A should take into account any differences in approach that may be required under section 7701(f) because section 246A defines portfolio indebtedness by reference to indebtedness ?directly attributable to" portfolio stock, while section 265(a)(2) refers to indebtedness ?incurred or continued to purchase or carry" tax-exempt obligations. Persons making comments may also wish to address the mandate in section 246A(f) to adopt regulations providing for interest disallowance, rather than disallowance of the dividends received deduction, when indebtedness is incurred by a person other than the person receiving dividends.

SPECIAL ANALYSIS

This advance notice of proposed rulemaking is not a significant regulatory action for purposes of Executive Order 12866, "Regulatory Planning and Review."

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-128590-03]

RIN 1545-BC23

Special Consolidated Return Rules for the Disallowance of Interest Expense Deductions under Section 265(a)(2)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 265(a)(2) that affect corporations filing consolidated returns. These regulations provide special rules for the treatment of certain intercompany transactions involving interest on intercompany obligations.

DATES: Written or electronic comments and requests for a public hearing must be received byAugust 5, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-128590-03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-128590-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-

128590-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Frances L. Kelly, (202) 622-7770; concerning submissions of comments and/or requests for a public hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 265(a)(2)

Section 163(a) generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. Under section 265(a)(2), however, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes.

Rev. Proc. 72-18 (1972-1 C.B. 740) provides guidelines for the application of section 265(a)(2) to taxpayers holding tax-exempt obligations. Section 3.01 of the revenue procedure states that the application of section 265(a)(2) requires a determination, based upon all the facts and circumstances, of the taxpayer's purpose in incurring or continuing each item of indebtedness. Such purpose may be established by either direct or circumstantial evidence. Direct evidence includes direct tracing of borrowed funds to investments in tax-exempt obligations and the pledging of tax-exempt obligations as security for the indebtedness. To the extent that there is direct evidence establishing a purpose to purchase or carry tax-exempt obligations, the interest paid or incurred on such indebtedness may not be deducted. In certain other cases when an interest deduction is disallowed (for example, when amounts borrowed by a dealer in tax-exempt obligations are not directly traceable to tax-exempt obligations), section 7 of

Rev. Proc. 72-18 sets forth a formula to calculate the disallowed interest deduction. That formula provides that the amount of the disallowed interest deduction is determined by multiplying the total interest on the indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted bases), and the denominator of which is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted bases) minus the amount of any indebtedness the interest deduction on which is not subject to disallowance to any extent under Rev. Proc. 72-18.

In H Enterprises International, Inc. v. Commissioner, 75 T.C.M. (CCH) 1948 (1998), aff'd, 183 F.3d 907 (8th Cir. 1999), a parent and a subsidiary were members of the same consolidated group of corporations. The subsidiary declared a dividend and, a few days later, borrowed funds and immediately used part of those funds to make the dividend distribution to the parent. A portion of the distributed funds was disbursed to two investment divisions of the parent, which used the funds to acquire investments including tax-exempt obligations.

The court held that a portion of the subsidiary's indebtedness was incurred for the purpose of purchasing or carrying tax-exempt obligations (held in the parent's investment divisions) and, therefore, no deduction was allowed for the interest on this portion of the indebtedness under section 265(a)(2). To establish the required purposive connection under section 265(a)(2), the court reasoned that the activities of the parent corporation were relevant in determining the subsidiary's purpose for borrowing the funds. The court stated that if the analysis only focused on the borrower and not the transferee, then the purpose of the borrower corporation would always be acceptable, frustrating the legislative intent of section 265(a)(2).

Rev. Rul. 2004-47 (2004-21 I.R.B.) provides guidance on the application of section 265(a)(2) in a number of situations in which a member of an affiliated group borrows money from an unrelated party and transfers funds to another member of the group that is a dealer in tax-exempt obligations. In Situation 4, P and S are members of the same affiliated group but file separate tax returns. P borrows funds from L, an unrelated bank, and lends the borrowed funds to S, a dealer in tax-exempt obligations. S uses the borrowed funds in its business. The ruling examines the obligation from L to P and the obligation from P to S for the application of section 265(a)(2). With regard to the loan from L to P, P uses the borrowed funds to make a loan to S, and P separately accounts for the taxable interest income from the obligation. The ruling concludes that P does not have a purpose of using the borrowed funds to purchase or carry tax-exempt obligations within the meaning of section 265(a)(2). With regard to the loan from P to S, although the borrowed funds are not directly traceable to S's purchase or carry of tax-exempt obligations, the ruling concludes that section 265(a)(2) applies to disallow a deduction for a portion of S's interest expense. The portion of S's interest deduction that is disallowed is determined pursuant to the formula of section 7 of Rev. Proc. 72-18.

The Intercompany Transaction Regulations

Section 1.1502-13 prescribes rules relating to the treatment of transactions between members of a consolidated group. With respect to intercompany obligations, the intercompany transaction rules generally operate to match the debtor member's items with the lending member's items from the intercompany obligation.

Under §1.1502-13(c)(6)(i), if section 265(a)(2) permanently and explicitly disallows a debtor member's interest deduction with respect to a debt to another member, the lending member's interest income is treated as excluded from gross income. See §1.1502-13(g)(5), Example 1(d). In cases when a member of the group borrows from another member to purchase or carry tax-exempt obligations, and the lending member has not borrowed from sources outside of the group to fund the intercompany obligation, the result reached under the §1.1502-13(c)(6)(i) exclusion rule is appropriate in that it reflects that intercompany lending transactions do not alter the net worth of the group and, thus, should not affect consolidated taxable income.

However, when the lending member borrows from a nonmember, the lending member lends those funds to the debtor member, and the debtor member uses those funds to purchase or carry tax-exempt obligations, the application of the §1.1502-13(c)(6)(i) exclusion rule may produce inappropriate results. For example, assume P borrows $100 from L, a nonmember, for the purpose of lending the $100 to S under the same terms, and S's purpose for borrowing $60 of the intercompany loan from P is to purchase $60 of tax-exempt obligations. Under section 265(a)(2), a deduction would be disallowed for a portion of S's interest expense on the intercompany obligation and a portion of P's interest income would be excluded from P's gross income under §1.1502-13(c)(6)(i). Accordingly, section 265(a)(2) may have no effect on the group's taxable income, even though the group has borrowed to purchase tax-exempt obligations.

Explanation of Provisions

The IRS and Treasury Department believe that, when a member's indebtedness to a nonmember is directly traceable to an intercompany obligation and another member of the group uses the funds borrowed from the nonmember to purchase or carry tax-exempt obligations, the net tax effect of these transactions for the group should be a disallowance of a deduction for interest under section 265(a)(2).

These proposed regulations reflect that when a member (P) borrows funds from a nonmember and lends all of those funds to another member (S) that uses those funds to purchase tax-exempt obligations, section 265(a)(2) will apply to disallow a deduction for the interest on S's obligation to P, not P's obligation to the nonmember. These proposed regulations provide that, if a member of a consolidated group incurs or continues indebtedness to a nonmember, that indebtedness to the nonmember is directly traceable to all or a portion of an intercompany obligation extended to a member of the group (the borrowing member) by another member of the group (the lending member), and section 265(a)(2) applies to disallow a deduction for all or a portion of the borrowing member's interest expense incurred with respect to the intercompany obligation, then §1.1502-13(c)(6)(i) will not apply to exclude an amount of the lending member's interest income with respect to the intercompany obligation that equals the amount of the borrowing member's disallowed interest deduction. This override of the exclusion rule is subject, however, to a limitation. In particular, the amount of interest income not excluded cannot exceed the interest expense on the portion of the nonmember indebtedness that is directly traceable to the intercompany obligation. This limitation ensures that applying section 265(a)(2) to disallow an interest deduction with respect to an intercompany obligation that can be directly traced to nonmember indebtedness does not result in a worse overall tax position for the group than applying section 265(a)(2) to disallow a deduction for the interest paid to the nonmember.

Therefore, subject to the limitation discussed above, if the proceeds of P's borrowing from a nonmember can be directly traced to a P-S intercompany obligation and all or a portion of S's interest expense on the P-S intercompany obligation is disallowed as a deduction under section 265(a)(2), these proposed regulations require that all or a portion of P's interest income on the intercompany obligation not be excluded under §1.1502-13(c)(6)(i).

In an Advance Notice of Proposed Rulemaking (REG-128572-03) in this issue of the **Federal Register**, the IRS and Treasury Department are soliciting comments regarding whether regulations under section 7701(f) should address the application of sections 265(a)(2) and 246A in transactions involving related parties, pass-thru entities, or other intermediaries, and suggestions as to the approach that should be taken by those regulations. It is possible that those comments and any regulations proposed under section 7701(f) will result in amendments to the rules set forth in these proposed regulations.

Proposed Effective Date

These regulations are proposed to apply to taxable years beginning on or after the date these regulations are published as final regulations 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 these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility A nalysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Frances L. Kelly, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1 -- INCOME TAXES

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

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

Section 1.265-2 also issued under 26 U.S.C. 1502 and 7701(f). * * *

Par. 2. In §1.265-2, paragraph (c) is added to read as follows:

§1.265-2 Interest relating to tax-exempt income.

* * * * *

(c) Special rule for consolidated groups--(1) Treatment of intercompany obligations--(i) Direct tracing to nonmember indebtedness . If a member of a consolidated group incurs or continues indebtedness to a nonmember, that indebtedness is directly traceable to all or a portion of an intercompany obligation (as defined in §1.1502-13(g)(2)(ii)) extended to a member of the group (B) by another member of the group (S), and section 265(a)(2) applies to disallow a deduction for all or a portion of B's interest expense incurred with respect to the intercompany obligation, then §1.1502-13(c)(6)(i) will not apply to exclude an amount of S's interest income with respect to the intercompany obligation that equals the amount of B's disallowed interest deduction.

(ii) Limitation. The amount of interest income to which §1.1502-13(c)(6)(i) will not apply as a result of the application of paragraph (c)(1)(i) of this section cannot exceed the interest expense on the portion of the indebtedness to the nonmember that is directly traceable to the intercompany obligation.

(2) Examples. The rules of this paragraph (c) are illustrated by the following examples. For purposes of these examples, unless otherwise stated, P and S are

members of a consolidated group of which P is the common parent. P owns all of the outstanding stock of S. The taxable year of the P group is the calendar year and all members of the P group use the accrual method of accounting. L is a bank unrelated to any member of the consolidated group. All obligations are on the same terms and conditions, remain outstanding at the end of the applicable year, and provide for payments of interest on December 31 of each year that are greater than the appropriate applicable Federal rate (AFR). The examples are as follows:

Example 1. (i) Facts. On January 1, 2005, P borrows $100x from L and lends the entire $100x of borrowed proceeds to S. S uses the $100x of borrowed proceeds to purchase tax-exempt securities. P's indebtedness to L is directly traceable to the intercompany obligation between P and S. In addition, there is direct evidence that the proceeds of S's intercompany obligation to P were used to fund S's purchase or carrying of tax-exempt obligations. During the 2005 taxable year, P incurs $10x of interest expense on its loan from L, and S incurs $10x of interest expense on its loan from P. Under section 265(a)(2), the entire $10x of S's interest expense on the intercompany obligation to P is disallowed as a deduction.

(ii) Analysis. Because section 265(a)(2) permanently and explicitly disallows $10x of S's interest expense, ordinarily $10x of P's interest income on the intercompany obligation would be redetermined to be excluded from P's gross income under §1.1502-13(c)(6)(i). However, under this paragraph (c), §1.1502-13(c)(6)(i) will not apply to exclude P's interest income with respect to the intercompany obligation in an amount that equals S's disallowed interest deduction with respect to the intercompany obligation. Accordingly, §1.1502-13(c)(6)(i) will not apply to exclude P's $10x of interest income on the intercompany obligation and P must include in income $10x of interest income from the intercompany obligation.

Example 2. (i) Facts. The facts are the same as in Example 1, except that P incurs only $8x of interest expense on its loan from L.

(ii) Analysis. Section 1.1502-13(c)(6)(i) will apply to exclude only a portion of P's $10x of interest income on the intercompany obligation. Under paragraph (c)(1)(ii) of this section, the amount of P's interest income that §1.1502-13(c)(6)(i) will not apply to exclude is $8x, the total interest expense incurred by P on its indebtedness to L. Consequently, P must include in income $8x of interest income from the intercompany obligation and §1.1502-13(c)(6)(i) will apply to exclude $2x of interest income from the intercompany obligation.

(3) Effective date. The provisions of this section shall apply to taxable years

beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 3. Section 1.1502-13 is amended by:

1. Adding a sentence immediately after the second sentence of paragraph (c)(6)(ii)(A).

2. Adding paragraph (c)(6)(iii).

3. Revising the first sentence of Example 1(d) of paragraph (g)(5).

The revisions and additions read as follows:

§1.1502-13 Intercompany transactions.

* * * * *

(c) * * *

(6) * * *

(ii) * * *

(A) * * * However, see §1.265-2(c) for special rules related to the application of paragraph (c)(6)(i) of this section to interest income with respect to certain intercompany obligations the interest deduction on which is disallowed under section 265(a)(2). * * *

* * * * *

(iii) Effective date. The third sentence of paragraph (c)(6)(ii)(A) of this section shall apply to taxable years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(g) * * *

(5) * * *

Example 1 * * *

* * * * *

(d) Tax-exempt income. The facts are the same as in paragraph (a) of this Example 1, except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies and §1.265-2(c) does not apply. * * *

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1516

Treasury Issues Guidance on Joint Ventures Between Tax Exempt Organizations And For-Profit Entities

The Treasury Department and the Internal Revenue Service today issued guidance on joint ventures between tax-exempt organizations and for-profit entities.

Revenue Ruling 2004-51 addresses whether an exempt organization that contributes a portion of its assets to, and conducts a portion of its activities through, a limited liability company (LLC) formed with a for-profit corporation continues to qualify for tax exemption. This ruling also addresses whether the exempt organization is subject to unrelated business income tax on income derived from the LLC.

"Tax-exempt organizations requested guidance on how to structure joint ventures when the joint venture represents only an insubstantial part of the exempt organization's activities," said Acting Assistant Secretary for Tax Policy Greg Jenner. "This ruling offers practical guidance on how the IRS will analyze whether the joint venture affects the organization's tax-exempt status or subjects the organization to unrelated business income tax."

-30-

REPORTS

- The text of Revenue Ruling 2004-51

Part I

Section 501 – Exemption from Tax on Corporations, Certain Trusts, Etc.; Section 513 – Unrelated Trade or Business

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals. (Also Sections 511-513.)

Rev. Rul. 2004-51, 2004-22 I.R.B (June 1, 2004)

ISSUES

1. Whether, under the facts described below, an organization continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation.

2. Whether, under the same facts, the organization is subject to unrelated business income tax under § 511 on its distributive share of the LLC's income.

FACTS

M is a university that has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). As a part of its educational programs, M offers summer seminars to enhance the skill level of elementary and secondary school teachers.

To expand the reach of its teacher training seminars, M forms a domestic LLC, L, with O, a company that specializes in conducting interactive video training programs. L's Articles of Organization and Operating Agreement ("governing documents") provide that the sole purpose of L is to offer teacher training seminars at off-campus locations using interactive video technology. M and O each hold a 50 percent ownership interest in L, which is proportionate to the value of their respective capital contributions to L. The governing documents provide that all returns of capital, allocations and distributions shall be made in proportion to the members' respective ownership interests.

The governing documents provide that L will be managed by a governing board comprised of three directors chosen by M and three directors chosen by O. Under the governing documents, L will arrange and conduct all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials and broadcasting the seminars to various locations. L's teacher training seminars will cover the same content covered in the seminars M conducts on M's campus. However, school teachers will participate through an interactive video link at various locations rather than in person. The governing documents grant M the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars. The governing documents grant O the exclusive right to select the locations where participants can receive a video link to the seminars and to approve other personnel (such as camera operators) necessary to conduct the video teacher training seminars. All other actions require the mutual consent of M and O.

The governing documents require that the terms of all contracts and transactions entered into by L with M, O and any other parties be at arm's length and that all contract and transaction prices be at fair market value determined by reference to the prices for comparable goods or services. The governing documents limit L's activities to conducting the teacher training seminars and also require that L not engage in any activities that would jeopardize M's exemption under § 501(c)(3). L does in fact operate in accordance with the governing documents in all respects.

M's participation in L will be an insubstantial part of M's activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

Because L does not elect under § 301.7701-3(c) of the Procedure and Administration Regulations to be classified as an association, L is classified as a partnership for federal tax purposes pursuant to § 301.7701-3(b).

LAW

Exemption under § 501(c)(3)

Section 501(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in § 501(c)(3). Activities that do not further exempt purposes must be an insubstantial part of the organization's activities. In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Supreme Court held that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement, an organization must "establish that it is not organized or operated for the benefit of private interests...."

Section 1.501(c)(3)-1(d)(2) defines the term "charitable" as used in § 501(c)(3) as including the advancement of education.

Section 1.501(c)(3)-1(d)(3)(i) provides, in part, that the term "educational" as used in § 501(c)(3) relates to the instruction or training of the individual for the purpose of improving or developing his capabilities.

Section 1.501(c)(3)-1(d)(3)(ii) provides examples of educational organizations including a college that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on and an organization that presents a course of instruction by means of correspondence or through the utilization of television or radio.

Joint Ventures

Rev. Rul. 98-15, 1998-1 C.B. 718, provides that for purposes of determining exemption under § 501(c)(3), the activities of a partnership, including an LLC treated as a partnership for federal tax purposes, are considered to be the activities of the partners. A § 501(c)(3) organization may form and participate in a partnership and meet the operational test if 1) participation in the partnership furthers a charitable purpose, and 2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

Redlands Surgical Services, 113 T.C. 47, 92-93 (1999), aff'd 242 F.3d 904 (9th Cir. 2001), provides that a nonprofit organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, "so long as the nonprofit organization does not thereby impermissibly serve private interests." The Tax Court held that the operational standard is not satisfied merely by establishing "whatever charitable benefits [the partnership] may produce," finding that the nonprofit partner lacked "formal or informal control sufficient to ensure furtherance of charitable purposes." Affirming the Tax Court, the Ninth Circuit held that ceding "effective control" of partnership activities impermissibly serves private interests. 242 F.3d at 904.

St. David's Health Care System v. United States, 349 F.3d 232, 236-237 (5th Cir. 2003), held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services." The nonprofit partner also must have the "capacity to ensure that the partnership's operations further charitable purposes." Id. at 243. "[T]he non-profit should lose its tax-exempt status if it cedes control to the for-profit entity." Id. at 239.

Tax on Unrelated Business Income

Section 511(a), in part, provides for the imposition of tax on the unrelated business taxable income (as defined in § 512) of organizations described in § 501(c)(3).

Section 512(a)(1) defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in

§ 513) regularly carried on by it less the deductions allowed, both computed with the modifications provided in § 512(b).

Section 512(c) provides that, if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to the organization, in computing its unrelated business taxable income, the organization shall, subject to the exceptions, additions, and limitations contained in § 512(b), include its share (whether or not distributed) of the gross income of the partnership from the unrelated trade or business and its share of the partnership deductions directly connected with the gross income.

Section 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

Section 1.513-1(d)(2) provides that a trade or business is "related" to an organization's exempt purposes only if the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is "substantially related" for purposes of § 513, only if the causal relationship is a substantial one. Thus, to be substantially related, the activity "must contribute importantly to the accomplishment of [exempt] purposes." Section 1.513-1(d)(2). Section 513, therefore, focuses on "the manner in which the exempt organization operates its business" to determine whether it contributes importantly to the organization's charitable or educational function. United States v. American College of Physicians, 475 U.S. 834, 849 (1986).

ANALYSIS

L is a partnership for federal tax purposes. Therefore, L's activities are attributed to M for purposes of determining both whether M operates exclusively for educational purposes and therefore continues to qualify for exemption under § 501(c)(3) and whether M has engaged in an unrelated trade or business and therefore may be subject to the unrelated business income tax on its distributive share of L's income.

The activities M is treated as conducting through L are not a substantial part of M's activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, M's participation in L, taken alone, will not affect M's continued qualification for exemption as an organization described in § 501(c)(3).

Although M continues to qualify as an exempt organization described in § 501(c)(3), M may be subject to unrelated business income tax under § 511 if L conducts a trade or business that is not substantially related to the exercise or performance of M's exempt purposes or functions.

The facts establish that M‘s activities conducted through L constitute a trade or business that is substantially related to the exercise and performance of M's exempt purposes and functions. Even though L arranges and conducts all aspects of the teacher training seminars, M alone approves the curriculum, training materials and instructors, and determines the standards for successfully completing the seminars. All contracts and transactions entered into by L are at arm's length and for fair market value, M's and O's ownership interests in L are proportional to their respective capital contributions, and all returns of capital, allocations and distributions by L are proportional to M's and O's ownership interests. The fact that O selects the locations and approves the other personnel necessary to conduct the seminars does not affect whether the seminars are substantially related to M's educational purposes. Moreover, the teacher training seminars L conducts using interactive video technology cover the same content as the seminars M conducts on M's campus. Finally, L's activities have expanded the reach of M's teacher training seminars, for example, to individuals who otherwise could not be accommodated at, or conveniently travel to, M's campus. Therefore, the manner in which L conducts the teacher training seminars contributes importantly to the accomplishment of M's educational purposes, and the activities of L are substantially related to M's educational purposes. Section 1.513-1(d)(2). Accordingly, based on all the facts and circumstances, M is not subject to unrelated business income tax under § 511 on its distributive share of L's income.

HOLDINGS

1. M continues to qualify for exemption under § 501(c)(3) when it contributes a portion of its assets to and conducts a portion of its activities through L.

2. M is not subject to unrelated business income tax under § 511 on its distributive share of L's income.

DRAFTING INFORMATION

The principal author of this revenue ruling is Virginia G. Richardson of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Virginia G. Richardson on (202) 283-8938 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1517

Treasury Issues Guidance On Mutual Funds

The Treasury Department and the Internal Revenue Service today issued guidance making available to mutual funds a simplifying assumption that is already available under the securities law.

"Applying the same, common-sense rule for both securities law and tax purposes will simplify compliance for mutual funds," said Acting Assistant Secretary for Tax Policy Gregory F. Jenner.

Mutual funds often invest excess cash on a short-term basis by entering repurchase or "repo" transactions in which the fund simultaneously buys a Treasury security and agrees to resell the security to the same person for a pre-arranged amount. In determining whether a fund satisfies the statutory diversification test, the fund's managers may now treat an investment in a repo of a Treasury security as if the investment were itself a Government security. Since August 2001, the SEC's Rule 5b–3 under the Investment Company Act of 1940 has permitted similar treatment.

-30-

REPORTS

- Rev. Proc. 2004–28

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters.
(Also Part I, ' ' 851, 852; 1.851-2)

Rev. Proc. 2004–28

SECTION 1. PURPOSE

This revenue procedure describes conditions under which a taxpayer that has invested in a repurchase agreement (repo) may treat its position in the repo as a Government security for purposes of qualifying as a regulated investment company (RIC) under the asset diversification test of section 851(b)(3) of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 A repo is a written agreement that provides for a “sale” and “repurchase” of a security or securities (the Aunderlying securities,@ or the Acollateral@). The purchaser agrees to purchase the underlying securities at a specific price and the seller, or Acounterparty,@ agrees to repurchase the same securities on a specific date for a specified price, plus an additional amount that reflects the time value of the purchaser=s investment from the date of purchase of the underlying securities to the date of their repurchase by the seller.

.02 RICs purchase securities in repo transactions as a convenient means to invest idle cash at competitive rates on a secured basis, generally for short periods of time. See Securities and Exchange Commission (SEC) Release No. IC–25058, 66 FR 36156, 36156–57 (July 11, 2001):

> While a repurchase agreement has legal characteristics of both a sale and a secured transaction, economically it functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan and are placed in the possession or under the control of the fund’s custodian during the term of the agreement. . . .
>
> . . . .
>
> A fund investing in a properly structured repurchase agreement looks primarily to the value and liquidity of the collateral rather than the credit of the counterparty for satisfaction of the repurchase agreement.

Id. at 36157 (footnote omitted).

.03 Section 851(b) provides that certain requirements must be satisfied for a domestic corporation to be taxed as a RIC under subchapter M, part I. Section 851(b)(3) imposes certain asset diversification requirements with respect to a RIC's total assets that must be satisfied as of the close of each quarter of the RIC=s taxable year.

.04 Section 851(b)(3)(A) requires that at least 50 percent of the value of a corporation's total assets be represented by cash and cash items (including receivables), Government securities, securities of other RICs, and other securities generally limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the RIC and to not more than 10 percent of the outstanding voting securities of such issuer.

.05 Section 851(b)(3)(B) provides that not more than 25 percent of the RIC's total assets may be invested in the securities (other than Government securities and the securities of other RICs) of any one issuer, or of two or more issuers that the RIC controls and that are determined, under regulations, to be engaged in the same or similar trades or businesses or related trades or businesses.

.06 Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. (1940 Act) defines a "diversified company" as a management company that has at least 75 percent of its assets invested in cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities that, for the purpose of this calculation, are limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the management company and to not more than 10 percent of the outstanding voting securities of the issuer. The remaining 25 percent of the management company=s assets may be invested in any manner.

.07 Effective August 15, 2001, the SEC adopted Rule 5b–3, which is intended to adapt the 1940 Act to the economic realities of repos and to reflect recent developments in bankruptcy law protecting parties to repos. SEC Release No. IC–25058. Subject to certain conditions, Rule 5b-3 permits a fund to Alook through@ the counterparty to the collateral in determining whether the fund is in compliance with the investment criteria for diversified funds set forth in section 5(b)(1) of the 1940 Act and with certain other securities laws.

.08 The following definition is set forth in Rule 5b–3:

(1) *Collateralized Fully* in the case of a repurchase agreement means that:

> (i) The value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the investment company reasonably could expect to incur if the seller defaults) is, and during the entire term of the repurchase agreement remains, at least equal to the Resale Price provided for in the agreement;
>
> (ii) The investment company has perfected its security interest in the collateral;
>
> (iii) The collateral is maintained in an account of the investment company with its custodian or a third party that qualifies as a custodian under the [1940] Act;
>
> (iv) The collateral consists entirely of :
>
> (A) Cash items;
>
> (B) Government securities;
>
> (C) Securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the requisite nationally recognized statistical rating organizations [as defined in Rule 5b–3(c)(5)]; or
>
> (D) Unrated Securities that are of comparable quality to securities that are rated in the highest rating category by the requisite nationally recognized statistical rating organizations, as determined by the investment company's board of directors or its delegate; and
>
> (v) Upon an Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.

Rule 5b–3(c)(1).

.09 The "Collateralized Fully" definition plays a critical role in the application of the 1940 Act diversification rules to repos:

> (a) *Repurchase Agreements.* For purposes of [the 1940 Act investment criteria for diversified investment companies and prohibition on registered investment companies from acquiring an interest in a broker-dealer, underwriter, or investment advisor], the acquisition of a repurchase agreement may be deemed to be an acquisition of the underlying securities, provided the obligation of the seller to repurchase the securities from the investment company is Collateralized Fully.

Rule 5b–3(a).

The effect of this rule is that, for purposes of the definition of a diversified investment company in section 5 of the1940 Act, if a repo is Collateralized Fully, a fund may (but need not) treat an investment in the repo as an investment in the underlying security or securities.

.10 Section 851(c)(5) provides that, for purposes of section 851(b)(3), all terms not specifically defined in section 851(c) shall have the same meaning as when used in the 1940 Act, as amended. The term AGovernment security@ is not specifically defined in section 851(c).

.11 Section 2(a)(16) of the 1940 Act defines the term AGovernment security@ for purposes of the 1940 Act without specific reference to funds investing in repos for which Government securities serve as collateral.

.12 The RIC diversification rules of subchapter M are substantially similar in structure and purpose to those of section 5(b)(1) of the 1940 Act. Both sets of rules impose numerical limitations on the percentages and types of assets that may be held by an investment company. Both sets of rules are intended to protect the investor from the risks of loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers. See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 820–26. In view of the commonality of structure and purpose of both sets of rules and in view of the need for RICS simultaneously to comply with both, the RIC diversification provisions of the Code and those of the1940 Act should be interpreted consistently.

SECTION 3. SCOPE

This revenue procedure applies to repos that, within the meaning of Rule 5b–3(c)(1), are Collateralized Fully with securities that qualify as Government securities for purposes of section 851(b)(3).

SECTION 4. PROCEDURE

If a taxpayer has invested in a repo to which this revenue procedure applies, the taxpayer may treat its position in that repo as a Government security for purposes of section 851(b)(3) even if the taxpayer is not treated as the owner of the underlying securities for federal tax purposes.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for repos held by a RIC on or after August 15, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Susan Thompson Baker of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact her at (202) 622-3940 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
js-1518

Treasury Announces $3.5 Billion To Help Nation's Low-Income Communities Through New Market Tax Credit Program

Secretary John W. Snow today announced that 62 organizations have been selected by the U.S. Department of the Treasury to receive a total of $3.5 billion in tax credit allocations through the second round of the New Markets Tax Credit (NMTC) Program. Secretary Snow highlighted today's awards in Racine, Wisconsin. Snow presented the Johnson Community Development Company with a $52 million NMTC allocation award to fund economic development projects in low-income areas promoting job growth and wealth creation throughout the state of Wisconsin and in Maricopa County, Arizona.

"President Bush and his administration are committed to creating opportunity and growth in every corner of this great country. This year's New Market Tax Credit awards will provide new hope for prosperity in many areas that have been particularly hard-hit," said Secretary John W. Snow.

Treasury Deputy Secretary Samuel W. Bodman presented NMTC awards today to five community development entities based in Massachusetts: Affirmative New Markets; Boston Community Capital Inc; Massachusetts Housing Investment Corporation; MassDevelopment New Markets, LLC; and Rockland Trust Community Development.

Secretary Snow will present certificates to the five NMTC recipients from Illinois at an event at the Pablo F. Friere Childcare Center in Chicago, Illinois, on Friday May 7.

The New Market Tax Credit Program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most. The NMTC Program, established by Congress in December 2000, permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The credit provided to the investor totals 39 percent of the initial value of the investment and is claimed over a seven-year credit allowance period. The 62 organizations receiving tax credit allocations this year were selected through a competitive application and rigorous review process.

"From foresting businesses in the communities of north-central Maine, to a start-up manufacturing business in south-eastern Ohio, to child-care facilities and needed shopping centers in many of our inner-city low-income neighborhoods, the New Markets Tax Credit Program has already begun to improve the communities in which these investments are being made," said Secretary Snow, highlighting the work already underway by organizations that received allocations of tax credits last year.

REPORTS

- List of Allocatees

CDFI FUND

US Department of the Treasury

NEW MARKETS TAX CREDIT PROGRAM:

2003 - 2004 New Markets Tax Credit Allocation Awardees

Affirmative New Markets LLC	Boston, MA	$12,000,000
Alaska Growth Capital BIDCO, Inc.	Anchorage, AK	$35,000,000
Banc of America CDE, LLC	Washington, DC	$150,000,000
Boston Community Capital Inc.	Boston,MA	$70,000,000
CBAI Community Development, Inc.	Indianapolis, IN	$50,000,000
CDF Development, LLC	Baltimore, MD	$100,000,000
Charter Facilities Funding, LLC	Phoenix, AZ	$50,000,000
Cincinnati New Markets Fund, LLC	Cincinnati, OH	$50,000,000
Coastal Enterprises, Inc.	Wiscasset, ME	$64,000,000
Commercial Federal Community Development Corporation	Omaha, NE	$23,000,000
Community Development Capital Partners, LLC	Wilmington, DE	$35,000,000
Community Development Funding, LLC	Clarksville, MD	$55,000,000
Community Reinvestment Fund New Markets I LP	Chicago, IL	$5,550,000
Community Revitalization Fund, Inc.	Hoffman Estates, IL	$73,000,000
Consortium America, LLC	Washington, DC	$110,000,000
Corporation for the Development of Community Health Centers	Austin, TX	$12,000,000
D.C.C.D. Corporation	Decaturville, TN	$2,250,000
Empowerment Reinvestment Fund, LLC	New York, NY	$25,000,000
ESIC New Markets Partners LP	Columbia, MD	$140,000,000
Florida Community Loan Fund, Inc.	Orlando, FL	$15,000,000
Great Lakes Region Sustainability Funds LLC	Chicago, IL	$15,000,000
GreenPoint New Markets, L.P.	New York, NY	$85,000,000
Harbor Bankshares Corporation	Baltimore, MD	$50,000,000
Heartland Renaissance Fund, LLC	Little Rock, AR	$15,000,000
HEDC New Markets	New York, NY	$135,000,000
Helios Capital Opportunity Fund LP	Dallas, TX	$25,000,000
Historic Rehabilitation Fund I	Portland, OR	$24,000,000
Hospitality Fund I	Portland, OR	$72,500,000
Independence Community Commercial Reinvestment Corp.	Brooklyn, NY	$113,000,000
Indiana Redevelopment Corporation	Indianapolis, IN	$25,000,000

Johnson Community Development Company	Racine, WI	$52,000,000
Kitsap County NMTC Facilitators I, LLC	Silverdale, WA	$40,000,000
Louisville Development Bancorp. Inc.	Louisville, KY	$62,500,000
Massachusetts Housing Investment Corporation	Boston, MA	$90,000,000
MassDevelopment New Markets LLC	Boston, MA	$70,000,000
Midwest Minnesota Community Development Corporation	Detroit Lakes, MN	$35,000,000
National Community Investment Fund	Chicago, IL	$38,000,000
National New Markets Tax Credit Fund, Inc	Minneapolis, MN	$150,000,000
NCB Development Corporation	Washington, DC	$75,000,000
New Hampshire New Market Investment Co., LLC	Saint Johnsbury, VT	$2,000,000
New Jersey Community Development Entity, LLC	Trenton, NJ	$125,000,000
Northeast Ohio Development Fund, LLC	Cleveland, OH	$47,000,000
Oak Hill Banks Community Development Corp.	Jackson, OH	$20,000,000
Ohio Community Development Finance Fund, The	Columbus, OH	$15,000,000
Peoples Economic Development Corporation	Fairfield, IL	$7,000,000
Pinnacle Community Development, Inc.	Nashville, TN	$6,000,000
Portland New Markets Fund I, LLC	Portland, OR	$100,000,000
Prestamos, CDFI, LLC	Phoenix, AZ	$15,000,000
Reinvestment Fund, Inc., The	Philadelphia, PA	$38,500,000
Related Community Development Group, LLC	New York, NY	$140,000,000
Rockland Trust Community Development LLC	Rockland, MA	$30,000,000
Rural Development Partners LLC	Hanlontown, IA	$61,700,000
Shorebank Enterprise Pacific	Ilwaco, WA	$8,000,000
Southside Development Enterprises LLC	Portsmouth, VA	$21,000,000
St. Louis Development Corporation	St. Louis, MO	$52,000,000
Stonehenge Community Development, LLC	Baton Rouge, LA	$127,500,000
TCG Community Enterprises, LLC	Rochester, NY	$125,000,000
The Mechanics Bank Community Development Corporation	Richmond, CA	$26,000,000
Urban Development Fund, LLC	Chicago, IL	$57,500,000
Wayne County - Detroit CDE	Detroit, MI	$27,000,000
Wisconsin Community Development Legacy Fund, INc.	Madison, WI	$100,000,000
Zions Community Investment Corp.	Salt Lake City, UT	$100,000,000

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
js-1519

Treasury Issues Guidance on Credit Card Fee Income

The Treasury Department and IRS today issued guidance regarding credit card annual fees and credit card late fees.

"The timing of income recognition for credit card annual fees has been a long-standing issue," said Acting Assistant Secretary for Tax Policy Gregory Jenner. "The guidance issued today will reduce controversy by addressing not only this issue, but also by addressing the treatment of credit card late fees

The revenue ruling issued today holds that income from credit card annual fees is not interest. A related revenue procedure allows credit card issuers to include income from credit card annual fees ratably over the period to which the fees relate.A second revenue procedure allows credit card issuers to treat income from late fees as interest.Both revenue procedures provide the exclusive procedures to obtain automatic consent from the Commissioner to change to the methods allowed under the respective revenue procedures.

-30

REPORTS

- Rev. Rul. 2004-52
- Rev. Proc. 2004-32
- Rev. Proc. 2004-33

Part I

Section 451BGeneral Rule for Taxable Year of Inclusion

26 CFR 1.451-1: Taxable Year of Inclusion
(Also: §§ 61, 446)

Rev. Rul. 2004-52

ISSUES

(1) Are credit card annual fees interest for federal income tax purposes?

(2) When are credit card annual fees includible in gross income by the card issuer?

FACTS

X, a taxpayer that uses an overall accrual method of accounting for federal income tax purposes, issues credit cards. Each card allows the cardholder to access a revolving line of credit to make purchases of goods and services and, if otherwise provided for under the applicable cardholder agreement, to obtain cash advances.

Credit card issuers, including X, charge certain cardholders an annual fee. These credit card issuers make various benefits and services available to their cardholders during the year, regardless of whether the cardholder actually utilizes them. Further, although they provide these benefits and services to cardholders, no part of the annual fee that is charged to any cardholder is for a specific benefit or service provided by a credit card issuer to that cardholder.

Each cardholder's credit card agreement sets forth the applicable terms and conditions under which X may charge that cardholder an annual fee. X charges some cardholders a nonrefundable annual fee. X charges other cardholders an annual fee that is refundable on a pro rata basis if the cardholder closes the account during the period covered by the fee.

Under the applicable cardholder agreement, no annual fee becomes due and payable until X posts an annual fee charge to the cardholder's credit card account. X reflects this posting in the cardholder's credit card statement. X generally posts the full amount of the annual fee in a single charge unless the terms of the agreement require X to post the annual fee charge in installments.

LAW AND ANALYSIS

For federal income tax purposes, interest is an amount that is paid in compensation for the use or forbearance of money. Deputy v. DuPont, 308 U.S. 488 (1940), 1940-1 C.B. 118; Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932), 1932-1 C.B. 274. Neither the label used for the fee nor a taxpayer=s treatment of the fee for financial or regulatory reporting purposes is determinative of the proper federal income tax characterization of that fee. See Thor Power Tool Co. v.

Commissioner, 439 U.S. 522, 542-43 (1979), 1979-1 C.B. 167, 174-75; Rev. Rul. 72-315, 1972-1 C.B. 49.

The annual fee that credit card issuers, including X, charge any cardholder is not for any specific benefit provided by the credit card issuer to that cardholder. Rather, it is charged for all of the benefits and services that are available to the cardholder under the applicable cardholder agreement. Because cardholders pay annual fees to credit card issuers, including X, in return for all of the benefits and services available under the applicable credit card agreement, annual fees are not compensation for the use or forbearance of money. Thus, X's annual fee income is not interest income for federal income tax purposes.

Under § 451(a) of the Internal Revenue Code, the amount of any item of gross income is includible in gross income for the taxable year in which it is received by the taxpayer, unless that amount is to be properly accounted for in a different period under the method of accounting used by the taxpayer in computing taxable income.

Under § 1.451-1(a) of the Income Tax Regulations, income is includible in gross income by a taxpayer that uses an accrual method of accounting when all events have occurred that fix the taxpayer's right to receive that income and the amount of that income can be determined with reasonable accuracy. See also § 1.446-1(c)(1)(ii)(A). Generally, all the events that fix the right to receive income occur when either the required performance takes place, payment is due, or payment is made, whichever occurs first (the all events test). See Rev. Rul. 2003-10, 2003-3 I.R.B. 288; Rev. Rul. 80-308, 1980-2 C.B. 162.

X is required to include these annual fees in gross income under § 1.451-1(a) when the fee income becomes due and payable under its agreements, because X's right to the income is fixed at that point and the amount of the income can be determined with reasonable accuracy. Thus, the all events test is satisfied when X posts an annual fee charge to a cardholder's credit card account even if X later is required to refund a portion of a previously posted refundable annual fee charge because the cardholder closes the account during the period covered by that fee.

Notwithstanding the holding of this revenue ruling, Rev. Proc. 2004-32, 2004-22 I.R.B. dated June 1, 2004, this bulletin, allows card issuers to account for annual fee income using the Ratable Inclusion Method for Credit Card Annual Fees, which is described in section 4 of that revenue procedure. Rev. Proc. 2004-32 also provides automatic consent for a taxpayer described in this revenue ruling to change its method of accounting for annual fee income.

HOLDINGS

(1) Credit card annual fees are not interest for federal income tax purposes.

(2) Credit card annual fees are includible in gross income by the card issuer when they become due and payable by cardholders under the terms of the credit card agreements.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Rebecca E. Asta, Alexa Dubert, and Tina Jannotta of the Office of Chief Counsel (Financial Institutions and Products).

For further information regarding this revenue ruling contact the principal authors on (202) 622-3930 (not a toll free call).

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also: §§ 446, 451)

Rev. Proc. 2004-32

SECTION 1. PURPOSE

This revenue procedure allows credit card issuers described in Rev. Rul. 2004-52, 2004-22 I.R.B. dated June 1, 2004, this Bulletin, to account for annual fee income using the Ratable Inclusion Method for Credit Card Annual Fees, which is set forth in section 4 of this revenue procedure. The procedure also provides automatic consent procedures for a credit card issuer within the scope of this revenue procedure to change its method of accounting for annual fee income.

SECTION 2. BACKGROUND

.01 Rev. Rul. 2004-52 describes certain taxpayers that issue credit cards. Each card allows the cardholder to access a revolving line of credit to make purchases of goods and services and, if otherwise provided by the applicable cardholder agreement, to obtain cash advances. These taxpayers may charge cardholders a credit card annual fee. Rev. Rul. 2004-52 holds that credit card annual fees are not interest for federal income tax purposes and that they are includible in income when the all events test under § 451 of the Internal Revenue Code is satisfied. Under the facts of Rev. Rul. 2004-52, the all events test is satisfied when the credit card annual fee becomes due and payable under the taxpayer's cardholder agreements.

.02 Any change in a taxpayer's treatment of income from credit card annual fees, including a change to conform the taxpayer's method to either Rev. Rul. 2004-52 or to the Ratable Inclusion Method for Credit Card Annual Fees, which is permitted by section 4 of this revenue procedure, is a change in method of accounting to which the provisions of §§ 446 and 481 apply.

.03 Under § 446(e) and § 1.446-1(e)(2)(i) of the Income Tax Regulations, a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions necessary to obtain consent to change a method of accounting. Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), provides procedures by which a taxpayer may obtain automatic consent to change to the methods of accounting described in the Appendix of Rev. Proc. 2002-9. Section 5.03 of Rev. Proc. 2002-9 provides that, unless otherwise provided, a taxpayer making a change in method of accounting under the revenue procedure must take into account a § 481(a) adjustment in the manner provided in section 5.04 of Rev. Proc. 2002-9.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer that uses an overall accrual method of accounting for federal income tax purposes and that issues credit cards to, and receives annual fees from, cardholders under agreements that allow each cardholder to use a credit card to access a revolving line of credit to make purchases of goods and services and, if so authorized, to obtain cash advances.

SECTION 4. RATABLE INCLUSION METHOD FOR CREDIT CARD ANNUAL FEES

.01 Permission to use the Ratable Inclusion Method for Credit Card Annual Fees. The Commissioner in an exercise of his discretion under § 446 permits taxpayers within the scope of this revenue procedure to account for their income from credit card annual fees using the Ratable Inclusion Method for Credit Card Annual Fees, which is described in this section 4.

.02 Description of method. Under the Ratable Inclusion Method for Credit Card Annual Fees, a credit card annual fee is recognized in income ratably over the period covered by the fee.

.03 Special rules. A taxpayer's use of the Ratable Inclusion Method for Credit Card Annual Fees does not clearly reflect its credit card annual fee income (and thus the Commissioner does not permit its use) unless the taxpayer also complies with the rules in section 4.03(1) and 4.03(2) of this revenue procedure.

(1) Closed accounts. If a credit card is cancelled or if a cardholder account is otherwise closed during a taxable year, any remaining unrecognized portion of the

credit card annual fee that is allocable to the account must be recognized in income in that year, unless the remaining portion is refunded.

(2) Fees billed in installments. If a credit card annual fee is due and payable in installments, each installment must be recognized ratably over the period to which the installment relates.

.04 Aggregation of fees. Taxpayers may account for income from credit card annual fees in an aggregate manner. A taxpayer that accounts for annual fees in an aggregate manner must establish that its recognition of credit card annual fee income satisfies the rules in sections 4.02 and 4.03 of this revenue procedure.

SECTION 5. CHANGE IN METHOD OF ACCOUNTING

A taxpayer within the scope of this revenue procedure that wants to change its method of accounting for income from credit card annual fees, either to a method that satisfies the all events test in accordance with Rev. Rul. 2004-52 or to the Ratable Inclusion Method for Credit Card Annual Fees that is described in section 4 of this revenue procedure, must follow the provisions of Rev. Proc. 2002-9 (or its successor), with the following modifications:

.01 The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for either its first or second taxable year ending on or after December 31, 2003; and

.02 The taxpayer must prepare and file a Form 3115 in accordance with section 6 of Rev. Proc. 2002-9 and must enter the designated number for the automatic change in method in Line 1a of Form 3115.

(1) The designated number for the automatic accounting method change to include credit card annual fees in income as required by Rev. Rul. 2004-52 is “80”.

(2) The designated number for the automatic accounting method change to the Ratable Inclusion Method for Credit Card Annual Fees is “81”.

SECTION 6. AUDIT PROTECTION

If a taxpayer within the scope of this revenue procedure currently uses the method described in section 4 of this revenue procedure, the method of accounting for the taxpayer’s credit card annual fees will not be raised as an issue by the Service in a taxable year that ends before December 31, 2003. Also, if a taxpayer currently uses the method described in section 4 of this revenue procedure, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, before an appeals office, or before the U.S. Tax Court for any taxable year that ends before December 31, 2003, that issue will not be further pursued by the Service.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in the APPENDIX.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2003.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Rebecca E. Asta, Alexa Dubert and Tina Jannotta of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact the principal authors on (202) 622-3930 (not a toll free call).

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601,204: Changes in accounting periods and in methods of accounting.
(Also: §§ 446, 1272)

Rev. Proc. 2004-33

SECTION 1. PURPOSE

This revenue procedure describes conditions under which the Commissioner will allow a taxpayer to treat its income from credit card late fees as interest income on a pool of credit card loans. This revenue procedure also provides the exclusive procedure by which a taxpayer within the scope of this revenue procedure may obtain the Commissioner's consent to change its method of accounting for income from credit card late fees to a method that treats these fees as interest that creates or increases the amount of original issue discount (OID) on the pool of credit card loans to which the fees relate.

SECTION 2. BACKGROUND

.01 Certain taxpayers issue credit cards that allow a cardholder to access a revolving line of credit to purchase goods and services. Some of these taxpayers may also issue credit cards that allow a cardholder to obtain cash advances.

.02 The terms and conditions that govern the cardholder's use of the credit card are provided in a credit card agreement. Under many credit card agreements, the cardholder is charged a fee when the cardholder is delinquent with respect to a payment due (late fee).

.03 For federal income tax purposes, interest is an amount that is paid in compensation for the use or forbearance of money. Deputy v. DuPont, 308 U.S. 488 (1940), 1940-1 C.B. 118; Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932), 1932-1 C.B. 274. Whether a fee is an interest charge for federal income tax purposes is determined by reference to all of the relevant facts and circumstances surrounding the imposition of the charge. Neither the label used for the charge (for example, a "finance charge") nor a taxpayer's treatment of the item for financial or regulatory reporting purposes is determinative of the proper federal income tax characterization of the fee. See Rev. Rul. 72-315, 1972-1 C.B. 49; see also Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979), 1979-1 C.B. 167.

.04 Rev. Rul. 74-187, 1974-1 C.B. 48, holds that late fees on utility bills are interest absent evidence that the late payment charge assessed by the public utility is for a specific service performed in connection with the customer's account. Even if a charge is a one-time charge or is imposed as a flat sum in addition to a stated periodic interest rate, that charge may still be interest for federal income tax purposes. See Rev. Rul. 77-417, 1977-2 C.B. 60, and Rev. Rul. 72-2, 1972-1 C.B. 19.

.05 Under § 1273(a)(1) of the Internal Revenue Code, OID is the excess of the stated redemption price at maturity (SRPM) of a debt instrument over the issue price of that instrument. Under § 1273(a)(2), the SRPM of a debt instrument is the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time, other than qualified stated interest (QSI). Under § 1.1273-1(b) of the Income Tax Regulations, the SRPM is the sum of all payments provided by the debt instrument other than QSI. Under § 1.1273-1(c), QSI is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) or that will be constructively received under § 451 at least annually at a single fixed rate.

.06 Section 1004 of the Taxpayer Relief Act of 1997, which is effective for taxable years beginning after August 5, 1997, extended the rules of § 1272(a)(6) to any pool of debt instruments the yield on which may be affected by reason of prepayments. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 522 (1997). Section 1272(a)(6) provides rules for determining the daily portions of OID if principal is subject to acceleration.

.07 Any change in the taxpayer's treatment of income from credit card late fees that affects when those fees are recognized in income is a change in method of accounting to which the provisions of §§ 446 and 481 apply. Under § 1.446-1(e)(2)(i), a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions necessary to obtain consent to change a method of accounting.

.08 Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), provides procedures by which taxpayers may obtain automatic consent to change to the methods of accounting described in the Appendix of Rev. Proc. 2002-9. Section 5.03 of Rev. Proc. 2002-9 provides that, unless otherwise provided, a taxpayer making a change in method of accounting under the revenue procedure must take into account a section 481(a) adjustment in the manner provided in section 5.04 of Rev. Proc. 2002-9.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer if—

.01 The taxpayer issues credit cards allowing cardholders to access a revolving line of credit established by the taxpayer; and

.02 None of the cardholders' credit card transactions with the taxpayer is treated by the taxpayer for federal income tax purposes as creating either debt that is given in consideration for the sale or exchange of property (within the meaning of §1274) or debt that is deferred payment for property (within the meaning of § 483).

SECTION 4. APPLICATION

.01 Subject to subsection .02 of this section 4, if a taxpayer is within the scope of this revenue procedure, the Commissioner will not challenge either the taxpayer's treatment of credit card late fees as interest or the taxpayer's treatment of this interest as being part of SRPM and thus as creating or increasing OID on a pool of credit card loans to which these fees relate.

.02 Subsection .01 of section 4 of this revenue procedure applies only if the taxpayer follows all of the requirements of section 5 of this revenue procedure and, if the taxpayer is changing its method of accounting, all of the requirements of section 6 of this revenue procedure.

SECTION 5. REQUIREMENTS

A taxpayer must be able to demonstrate the following:

.01 The amount of any credit card late fee charged to each cardholder by the taxpayer is separately stated on the cardholder's account when the late fee is imposed; and

.02 Under the applicable credit card agreement governing each cardholder's use of the credit card, no amount identified as a credit card late fee is charged for property or for specific services performed by the taxpayer for the benefit of the cardholder.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

If a taxpayer within the scope of this revenue procedure wants to change its method of accounting for income from credit card late fees and if, under the method to which the taxpayer is changing, these fees are treated as interest that creates or increases the amount of OID on a pool of credit card loans to which these fees relate, the taxpayer must follow the provisions of Rev. Proc. 2002-9 (or its successor), with the following modifications:

.01 The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for either its first or second taxable year ending on or after December 31, 2003; and

.02 The taxpayer must prepare and file a Form 3115 in accordance with section 6 of Rev. Proc. 2002-9 and enter the designated number ("82") for this automatic change in method in Line 1a of Form 3115.

SECTION 7. AUDIT PROTECTION

.01 If a taxpayer within the scope of this revenue procedure currently uses a method of accounting that treats credit card late fees as interest that creates or increases the amount of OID on a pool of credit card loans to which these fees relate, the issue of whether the taxpayer is properly treating its credit card late fees as OID on a pool of credit card loans will not be raised by the Commissioner in a taxable year that ends before December 31, 2003.

.02 If a taxpayer within the scope of this revenue procedure currently uses a method of accounting that treats credit card late fees as interest that creates or increases the amount of OID on a pool of credit card loans to which these fees relate and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, before an appeals office, or before the U.S. Tax Court for any taxable year that ends before December 31, 2003, that issue will not be further pursued by the Service.

.03 Neither the audit protection provided in connection with a change in a taxpayer's method of accounting for credit card late fees that is properly made under section 6 of this revenue procedure, nor the audit protection provided under sections

7.01 and 7.02 of this revenue procedure, is a determination by the Commissioner that the taxpayer is properly accounting for any OID income on that pool of credit card loans. Thus, for example, the Service is not precluded from pursuing the issue of whether a taxpayer is properly accounting for its OID income (including any OID attributable to late fees) on its pool of credit card loans in accordance with § 1272(a)(6).

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in the APPENDIX.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2003.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Rebecca E. Asta, Alexa Dubert and Tina Jannotta of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact the principal authors on (202) 622-3930 (not a toll free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
JS-1520

Deputy Secretary of the Treasury
Samuel W. Bodman
Remarks to the NH Business Council Annual Legislative Breakfast
May 6, 2004

I'm very pleased to be here with all of you today. Having spent nearly 40 years in Boston, it's always a pleasure to be among colleagues from the New England business community.

I'd like to thank Governor Benson, Senator Eaton and Speaker Chandler for being here and for your support of the New Hampshire business community. And I especially want to acknowledge the eight legislators who are being honored this morning. As leaders in the New Hampshire State House, you share my desire and determination - you share President Bush's desire and determination - to do all we can to create the best environment for businesses to grow and flourish here in New Hampshire and across this great nation.

You know that government doesn't create wealth in this country, American business does. Business is the engine of growth, innovation and prosperity that keeps our nation moving forward. But government does have a role and that role is to create the conditions for economic growth and job creation. Since his very first days in office, President Bush has consistently proposed and supported policies that do just that. From decisive action to lower the tax burden on American consumers and businesses . . . to confronting the rising costs of doing business in this country . to pushing hard to open foreign markets and promote fair competition.

And, as we survey our economic situation today, it is clear that the President's policies are having a very real and positive impact. Just last week we got the first read-out of GDP for the first quarter of this year. The economy grew at a solid 4.2 percent. The last nine months represent the strongest three-quarter growth rate in almost 20 years.

Further evidence of the recovery underway: We are starting to see a pick-up in the manufacturing sector. And, the housing industry remains very strong. Construction is booming - we just got a very strong construction report for March earlier this week. Home ownership is at an all-time high of nearly 69%, with substantial gains among minority households. Business confidence is up and business investment has rebounded.

In addition, we are beginning to see some come-back in the labor markets. The economy has created over 750,000 jobs in the last seven months, with 300,000 coming in March alone. Layoffs are down, unemployment is down, and help wanted ads are up. Initial claims for unemployment insurance have fallen substantially - down 20% over the last year.

I can assure you that the President and this entire Administration are very focused on employment . . the President will not rest until every American who wants to work can find a job. By sustaining growth going forward, I am confident that we will see job creation continue in the months ahead.

In light of our economy's momentum, one thing is clear: we must make the President's tax cuts permanent. The tax cuts have been the linchpin of the improving performance of the economy . . . and I believe that if we make them permanent, we will continue to have above-normal growth for the American economy for a good stretch of years.

Now, some have proposed repealing or significantly scaling back the tax cuts . . . and, to be sure, what that really means is that they want to raise taxes. Some cite concerns about the deficit. And I can tell you this: the deficit is a great concern for the President as well. Deficits do matter. But raising taxes is not the answer. Higher tax rates are a powerful disincentive for growth, and would be the wrong medicine for our economy and its job-creating potential.

Our budget deficit while unwelcome is understandable and manageable. While addressing the deficit, we must remember that it is not historically overwhelming. It is understandable given the extraordinary circumstances of recent history. The American people and the American economy have endured a tremendous amount of strain in recent years - from a recession, which thanks to the President's policies was much milder than it would have been . . . to the horrific terrorist attacks of September 11th, 2001 . . . to the uncertainty that surrounded the march to war in Afghanistan and Iraq. These are not excuses, for sure, but they do put the deficit situation in context.

Nonetheless, we will bring the deficit down quickly. The President's budget plan cuts the deficit in half over five years, bringing it to a level that is historically low as a percentage of GDP (less than 2% of GDP). Economic growth is key to the prosperity of our citizens . . . and it also it increases Treasury receipts and helps to reduce deficits. But that isn't enough. We also have to control government spending in Washington. We need to do both - make tax cuts permanent and control spending - and the President is committed to doing both.

But there is still more to do. To help businesses continue to expand and create more jobs, the President has called on Congress:

- To take action to reduce frivolous and junk lawsuits;
  To make Federal regulations less burdensome on small businesses;
- To enact a national energy policy that ensures a more affordable and reliable supply of energy, and makes us less dependent on foreign energy sources;
_ To continue to open foreign markets to American products and services - we will not isolate America from opportunities;
  And we must make health care more affordable for families and small businesses.

Let me say a bit more on the topic of health care. At a time when health care costs are rising rapidly and families and employers are struggling to find lower-cost alternatives, we need new ideas and innovative solutions. One such option - and one that I believe has real potential to make a big difference is Health Savings Accounts, or "HSAs."

Health Savings Accounts were created by the Medicare bill signed by President Bush in December. HSAs are designed with two major goals in mind: first, to help individuals take control of how their health care dollars are spent; and second, to help families save for future medical and retiree health expenses on a tax-free basis.

Let me cover a few basic features of the HSA program. In order to make a contribution to a Health Savings Account, an individual or family must be covered by a High Deductible Health Plan and have no other coverage. A High Deductible Plan is defined as having a minimum deductible of $1,000 for individual coverage or $2,000 deductible for family coverage . . . and it generally only pays for benefits after the deductible is met.

Both individuals and their employers can contribute to HSAs. And this provides a lot of options and flexibility for small employers struggling to keep costs reasonable for their business and for their employees. Individuals, employers, or both can contribute tax-deductible funds each year up to the amount of the policy's annual deductible, subject to a cap of $2,600 for individuals and $5,150 for families. Individuals aged 55-64 can make additional contributions. Contributions to an HSA by an employer are not included in the individual's taxable income . . and contributions by an individual are completely tax deductible and are not subject to the itemized deduction limits.

When a family needs the money, if it is used for qualified medical expenses, the distribution is tax free. A few examples . the money in an HSA can be used to pay for: medical expenses not covered by the high deductible plan; health insurance if an individual becomes unemployed; health insurance or medical expenses after retirement; and long-term care expenses and long-term care insurance premiums. HSAs will encourage families to save for future medical expenses and will empower them to make decisions about their own health care.

The flexibility of these accounts is a big draw for employers and employees. Health Savings Accounts are completely portable if an employee changes jobs, moves to another state, gets married, becomes unemployed, or changes health plans in the future. Accounts can grow through investment earnings. Many different investment options can be pursued based on a family's needs. And the interest and investment earnings generated by the account are not taxable while in the HSA. In addition, there are no "use it or lose it rules" like Flexible Spending Arrangements (FSAs). Unspent balances remain in the account year after year.

I hope, in particular, that HSAs will appeal to the small-business community, which faces the highest hurdles when it comes to affording coverage for their employees. By utilizing these flexible accounts and purchasing health insurance plans with a higher deductible, small businesses should be able to lower health insurance premiums and expand coverage options for their employees. I am told that that recent changes to insurance laws in New Hampshire mean that HSA products are already being sold here . . . and we hope more are on the way.

For more on the technical specifics of HSAs, I encourage you to visit the Treasury Department's web site at www.treasury.gov. There is an extensive section devoted to HSAs, which includes answers to frequently asked questions as well as details on implementation guidance. Treasury issued technical guidance in December and again in March, and we expect to issue additional guidance in June, so check for that.

As with any new product, one of the greatest challenges is getting the word out and helping people understand how it works. That's one of the reasons why I'm so glad to be here today.

I would also add that we need to continue to work together - the private sector and those of us in government at the state and federal levels - to explore policy solutions that make health care more affordable for businesses and families. In this and other areas, I can assure you that this Administration will remain committed to making sure federal policies encourage and support economic growth and job creation throughout our economy.

As everyone in this room well knows, our business enterprises - our nation's employers are the foundation of the strongest, most vigorous and vibrant free enterprise system in history. . . a system that allows you to innovate . . . to take risks . . to create wealth . . . and sometimes, to fail and start over. I thank you for the fine work that you do here in New Hampshire and across the country . . and I thank you for being here today and for inviting me to join you.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
JS-1521

Deputy Secretary of the Treasury Samuel W. Bodman
Remarks at New Markets Tax Credit Event
Hibernian Hall; Roxbury, Massachusetts
May 6, 2004

I'm very pleased to be back in Boston, and particularly glad to be here to share such great news. Today we are announcing allocations of New Markets Tax Credits to five Massachusetts-based Community Development Entities. The allocations total over $270 million for communities in Massachusetts.

The New Markets Tax Credit program is an important community and economic development tool. It was created to encourage business investment and job creation in communities like this one.

The goal is to attract capital from the private sector and to empower the people who live, work and invest in communities to make decisions about what type of ventures will create the most jobs and grow the local economy.

The message that this program sends is – this community is a good place to do business. Today's announcement is a step toward a brighter future for this neighborhood and many others throughout Massachusetts.

New Markets Tax Credits are available to individual and corporate taxpayers who make qualified equity investments in privately managed investment vehicles called Community Development Entities (or CDEs).

CDEs serve or provide investment capital for low-income communities, and they are certified by the Community Development Financial Institutions (CDFI) Fund of the U.S. Department of the Treasury. These tax credit allocations are awarded through a competitive process.

It is now my pleasure to announce the five awardees from Massachusetts. As I read out the name of each organization, I ask the representatives to come forward.

The first awardee is Affirmative New Markets LLC, headquartered here in Boston. Affirmative New Markets' strategy is to invest in real estate projects to finance the development of office and community space in low-income communities. They plan to use this allocation to provide loan and equity capital investments in two real estate development projects – one in Boston and the other on Cape Cod. These projects will make the commercial space more affordable to the end users, thereby allowing non-profits and other community organizations to remain in the low-income communities that they serve.

Next is Boston Community Capital Inc. (or BCC). BCC will use its New Markets Tax Credit allocation to provide loans to support businesses and real estate development in low-income communities. Because of this program, BCC will be able to significantly increase the volume of its lending activity and provide more flexible terms to borrowers, such as below market interest rates, lower origination fees, higher loan-to-value ratios, and longer interest-only loan payment periods. BCC will also use the equity generated by its allocation to secure financing to support another credit facility, separate and apart from its New Markets Tax Credit fund, to provide additional financing to low-income communities.

Our next awardee is the Massachusetts Housing Investment Corporation (MHIC). Eligible projects to be financed with this allocation include community centers, office and retail space, theatres and performing arts centers, and studios and gallery space. The New Market Tax Credits will enable MHIC to offer interest-only first mortgage loans, zero to five percent interest-only subordinate loans, and equity investments that represent up to 25 percent of total development costs. In fact, this Hibernian Hall renovation project was made possible by an investment from the Massachusetts Housing Investment Corporation (MHIC). Once refurbished, this building will contain a performance center, retail and office space, and a new computer learning center.

Now I am pleased to call forward MassDevelopment New Markets LLC. MassDevelopment will utilize its allocation to offer flexible, nontraditional loans for business investments in low-income communities. It will finance four specific real estate redevelopment projects that are on Brownfield's sites and are of critical importance to some of the most deeply distressed communities across the state.

And finally we have Rockland Trust Community Development LLC, headquartered in Rockland, Massachusetts. Rockland Trust's allocation will support business lending targeted at low-income communities in the four southeastern Massachusetts counties of Barnstable, Bristol, Norfolk, and Plymouth. In conjunction with its lending activities, Rockland Trust will also provide financial counseling to businesses within low-income communities, both to assist them with New Markets Tax Credits requirements and in obtaining complementary equity and debt financing from other public and private sources.

Congratulations to a great group of awardees. I'm very pleased to be a part of this event today.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 6, 2004
JS-1522

Treasury Issues Guidance On Advance Payments

The Treasury Department and IRS issued a revenue procedure that provides taxpayers that use an accrual method of accounting a limited deferral beyond the year of receipt for certain types of advance payments. The revenue procedure finalizes a proposed revenue procedure published in late 2002. An accompanying announcement discusses the most significant issues considered in connection with finalizing the revenue procedure.

Although, generally taxpayers must include advance payments for goods or services in income in the taxable year received, existing regulations allow taxpayers to defer certain advance payments for goods and prior guidance provided a safe harbor method for taxpayers to obtain a limited deferral to the following taxable year for certain advance payments for services.

"The existing rules led to considerable controversy regarding the types of advance payments that qualified for deferral," stated Acting Treasury Assistant Secretary for Tax Policy Greg Jenner. "The revenue procedure issued today will reduce controversy by expanding and clarifying the types of payments that qualify for deferral."

In addition to allowing deferral of payments for services, the revenue procedure also allows limited deferral of certain other payments. If only part of a payment qualifies for deferral, the revenue procedure allows partial deferral. Although deferrals under the new revenue procedure generally are limited to one taxable year, the revenue procedure includes a special rule allowing deferral for two taxable years in the case of certain short taxable years. In addition, the revenue procedure allows deferral to the following taxable year even if the term of the agreement extends beyond the end of the following taxable year. Taxpayers may also continue to use the existing regulations to defer advance payments for goods

-30-

REPORTS

- Rev. Proc. 2004-34
- Announcement 2004-38

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 446, 451; 1.446-1, 1.451-1.)

Rev. Proc. 2004-34

SECTION 1. PURPOSE

This revenue procedure allows taxpayers a limited deferral beyond the taxable year of receipt for certain advance payments. Qualifying taxpayers generally may defer to the next succeeding taxable year the inclusion in gross income for federal income tax purposes of advance payments (as defined in section 4 of this revenue procedure) to the extent the advance payments are not recognized in revenues (or, in certain cases, are not earned) in the taxable year of receipt. Except as provided in section 5.02(2) of this revenue procedure for certain short taxable years, this revenue procedure does not permit deferral to a taxable year later than the next succeeding taxable year. This revenue procedure neither restricts a taxpayer=s ability to use the methods provided in ' 1.451-5 of the Income Tax Regulations regarding advance payments for goods nor limits the period of deferral available under ' 1.451-5.

This revenue procedure also provides the exclusive administrative procedures under which a taxpayer within the scope of this revenue procedure may obtain consent to change to a method of accounting provided in section 5 of this revenue procedure.

SECTION 2. BACKGROUND AND CHANGES

.01 In general, ' 451 of the Internal Revenue Code provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. *See* Rev. Rul. 84-31, 1984-1 C.B. 127.

.02 Section 1.451-5 generally allows accrual method taxpayers to defer the inclusion in gross income for federal income tax purposes of advance payments for goods until the taxable year in which they are properly accruable under the taxpayer=s method of accounting for federal income tax purposes if that method results in the advance payments being included in gross income no later than when the advance payments are recognized in revenues under the taxpayer=s method of accounting for financial reporting purposes.

.03 Rev. Proc. 71-21, 1971-2 C.B. 549, was published to implement an administrative decision of the Commissioner in the exercise of his discretion under ' 446 to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. Rev. Proc. 71-21 was designed to reconcile the federal income tax and financial accounting treatment of payments received for services to be performed by the end of the next succeeding taxable year without permitting extended deferral of the inclusion of those payments in gross income for federal income tax purposes.

.04 Considerable controversy exists about the scope of Rev. Proc. 71-21. In particular, advance payments for non-services (and often, for combinations of services and non-services) do not qualify for deferral under Rev. Proc. 71-21, and taxpayers and the Internal Revenue Service frequently disagree about whether advance payments are, in fact, for "services." In addition to the issue of defining Aservices@ for purposes of Rev. Proc. 71-21, questions also arise about whether advance payments received under a series of agreements, or under a renewable agreement, are within the scope of Rev. Proc. 71-21. In the interest of reducing the controversy surrounding these issues, the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments for certain non-services and combinations of services and non-services. Additionally, the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments received in connection with an agreement or series of agreements with a term or terms extending beyond the end of the next succeeding taxable year. The Service has determined, however, that for taxpayers deferring recognition of income under this revenue procedure it is appropriate to retain the limited one-year deferral of Rev. Proc. 71-21 (except as provided in section 5.02(2) of this revenue procedure for certain short taxable years).

SECTION 3. SCOPE

This revenue procedure applies to taxpayers using or changing to an overall accrual method of accounting that receive advance payments as defined in section 4 of this revenue procedure.

SECTION 4. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure --

.01 *Advance Payment.* Except as provided in section 4.02 of this revenue procedure, a payment received by a taxpayer is an Aadvance payment@ if --

(1) including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes (without regard to this revenue procedure);

(2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) for a subsequent taxable year (or, for taxpayers without an applicable financial statement as defined in section 4.06 of this revenue procedure, the payment is earned by the taxpayer (in whole or in part) in a subsequent taxable year); and

(3) the payment is for --

(a) services;

(b) the sale of goods (other than for the sale of goods for which the taxpayer uses a method of deferral provided in ' 1.451-5(b)(1)(ii));

(c) the use (including by license or lease) of intellectual property as defined in section 4.03 of this revenue procedure;

(d) the occupancy or use of property if the occupancy or use is ancillary to the provision of services (for example, advance payments for the use of rooms or other quarters in a hotel, booth space at a trade show, campsite space at a mobile home park, and recreational or banquet facilities, or other uses of property, so long as the use is ancillary to the provision of services to the property user);

(e) the sale, lease, or license of computer software;

(f) guaranty or warranty contracts ancillary to an item or items described in subparagraph (a), (b), (c), (d), or (e) of this section 4.01(3);

(g) subscriptions (other than subscriptions for which an election under ' 455 is in effect), whether or not provided in a tangible or intangible format;

(h) memberships in an organization (other than memberships for which an election under ' 456 is in effect); or

(i) any combination of items described in subparagraphs (a) through (h) of this section 4.01(3).

.02 *Exclusions From Advance Payment.* The term Aadvance payment@ does not include --

(1) rent (except for amounts paid with respect to an item or items described in subparagraph (c), (d), or (e) of section 4.01(3));

(2) insurance premiums, to the extent the recognition of those premiums is governed by Subchapter L;

(3) payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements, financial derivatives, etc.), including purported prepayments of interest;

(4) payments with respect to service warranty contracts for which the taxpayer uses the accounting method provided in Rev. Proc. 97-38, 1997-2 C.B. 479;

(5) payments with respect to warranty and guaranty contracts under which a third party is the primary obligor;

(6) payments subject to § 871(a), 881, 1441, or 1442; and

(7) payments in property to which § 83 applies.

.03 *Intellectual Property.* The term Aintellectual property@ includes copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights (such as franchise rights and arena naming rights).

.04 *Received.* Income is Areceived@ by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer.

.05 *Next Succeeding Taxable Year.* The term Anext succeeding taxable year@ means the taxable year immediately following the taxable year in which the advance payment is received by the taxpayer.

.06 *Applicable Financial Statement.* The taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (1) through (3) of this section 4.06

that has the highest priority (including within paragraph (2)). A taxpayer that does not have a financial statement described in paragraphs (1) through (3) of this section 4.06 does not have an applicable financial statement for purposes of this revenue procedure. The financial statements are, in descending priority --

(1) a financial statement required to be filed with the Securities and Exchange Commission ("SEC") (the 10-K or the Annual Statement to Shareholders);

(2) a certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign corporation, by the report of a similarly qualified independent professional), that is used for –

(a) credit purposes,
(b) reporting to shareholders, or
(c) any other substantial non-tax purpose; or

(3) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the Internal Revenue Service).

SECTION 5. PERMISSIBLE METHODS OF ACCOUNTING FOR ADVANCE PAYMENTS

.01 *Full Inclusion Method.* A taxpayer within the scope of this revenue procedure that includes the full amount of advance payments in gross income for federal income tax purposes in the taxable year of receipt is using a proper method of accounting under ' 1.451-1, regardless of whether the taxpayer recognizes the full amount of advance payments in revenues for that taxable year for financial reporting purposes and regardless of whether the taxpayer earns the full amount of advance payments in that taxable year.

.02 *Deferral Method.*

(1) *In general.*

(a) A taxpayer within the scope of this revenue procedure that chooses to use the Deferral Method described in this section 5.02 is using a proper method of accounting under ' 1.451-1. Under the Deferral Method, for federal income tax purposes the taxpayer must –

(i) include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2) of this revenue procedure) to the extent provided in section 5.02(3) of this revenue procedure, and

(ii) except as provided in section 5.02(2) of this revenue procedure, include the remaining amount of the advance payment in gross income for the next succeeding taxable year.

(b) Except as provided in section 5.02(3)(b) of this revenue procedure, a taxpayer using the Deferral Method must be able to determine –

(i) the extent to which advance payments are recognized in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) in the taxable year of receipt (and a short taxable year described in section 5.02(2) of this revenue procedure, if applicable), or

(ii) if the taxpayer does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), the extent to which advance payments are earned (as described in section 5.02(3)(b) of this revenue procedure), in the taxable year of receipt (and a short taxable year described in section 5.02(2) of this revenue procedure, if applicable).

(2) *Short taxable years.* If the next succeeding taxable year is a taxable year (other than a taxable year in which the taxpayer dies or ceases to exist in a transaction other than a transaction to which § 381(a) applies) of 92 days or less, a taxpayer using the Deferral Method must include the portion of the advance payment not included in the taxable year of receipt in gross income for the short taxable year to the extent provided in section 5.02(3) of this revenue procedure. Any amount of the advance payment not included in the taxable year of receipt and the short taxable year must be reported in gross income for the taxable year immediately following the short taxable year.

(3) *Inclusion of advance payments in gross income.*

(a) Except as provided in paragraph (b) of this section 5.02(3), a taxpayer using the Deferral Method must --

(i) include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2) of this revenue procedure) to the extent recognized in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) for that taxable year, and

(ii) include the remaining amount of the advance payment in gross income in accordance with section 5.02(1)(a)(ii) of this revenue procedure.

(b) If the taxpayer does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), or if the taxpayer is unable to determine, as required by section 5.02(1)(b)(i) of this revenue procedure, the extent to which advance payments are recognized in revenues in its applicable financial statements for the taxable year of receipt (and a short taxable year described in section

5.02(2) of this revenue procedure, if applicable), a taxpayer using the Deferral Method must include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2)) to the extent earned in that taxable year and include the remaining amount of the advance payment in gross income in accordance with section 5.02(1)(a)(ii) of this revenue procedure. The determination of whether an amount is earned in a taxable year must be made without regard to whether the taxpayer may be required to refund the advance payment upon the occurrence of a condition subsequent. If the taxpayer is unable to determine the extent to which a payment (such as a payment for contingent goods or services) is earned in the taxable year of receipt (and, if applicable, in a short taxable year described in section 5.02(2)), the taxpayer may determine that amount --

(i) on a statistical basis if adequate data are available to the taxpayer;

(ii) on a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(iii) by the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

(4) *Allocable payments.*

(a) *General rule.* A taxpayer that receives a payment that is partially attributable to an item or items described in section 4.01(3) of this revenue procedure may use the Deferral Method for the portion of the payment allocable to such item or items and, with respect to the remaining portion of the payment, may use any proper method of accounting (including the Deferral Method if the remaining portion of the advance payment is for an item or items described in section 4.01(3) of this revenue procedure with a different deferral period (based on the taxpayer's applicable financial statement or the earning of the payment, as applicable)), provided that the taxpayer's method for determining the portion of the payment allocable to such item or items is based on objective criteria.

(b) *Advance payments under section 4.01(3)(i).* An advance payment under section 4.01(3)(i) that is wholly attributable to two or more items described in subparagraphs (a) through (h) of section 4.01(3) of this revenue procedure that have the same deferral period (based on the taxpayer's applicable financial statement or the earning of the payment, as applicable) is not an allocable payment under section 5.02(4)(a) of this revenue procedure.

(c) *Allocation deemed to be based on objective criteria.* A taxpayer's allocation method with respect to an allocable payment described in section

5.02(4)(a) of this revenue procedure will be deemed to be based on objective criteria if the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately.

(5) *Acceleration of advance payments.* Notwithstanding section 5.02(1) of this revenue procedure, a taxpayer using the Deferral Method must include in gross income for the taxable year of receipt (or, if applicable, for a short taxable year described in section 5.02(2) of this revenue procedure) all advance payments not previously included in gross income –

(a) if, in that taxable year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which § 381(a) applies, or

(b) if, and to the extent that, in that taxable year, the taxpayer=s obligation with respect to the advance payments is satisfied or otherwise ends other than in --

(i) a transaction to which § 381(a) applies, or

(ii) a § 351(a) transfer in which (a) substantially all assets of the trade or business (including advance payments) are transferred, (b) the transferee adopts or uses the Deferral Method in the year of transfer, and (c) the transferee and the transferor are members of an affiliated group of corporations that file a consolidated return, pursuant to §§ 1504 – 1564.

.03 *Examples.* In each example below, the taxpayer uses an accrual method of accounting for federal income tax purposes and files its returns on a calendar year basis. Except as stated otherwise, the taxpayer in each example has an applicable financial statement as defined in section 4.06 of this revenue procedure.

Example 1. On November 1, 2004, *A*, in the business of giving dancing lessons, receives an advance payment for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. *A* provides eight lessons in 2004 and another 35 lessons in 2005. In its applicable financial statement, *A* recognizes 1/6 of the payment in revenues for 2004, and 5/6 of the payment in revenues for 2005. *A* uses the Deferral Method. For federal income tax purposes, *A* must include 1/6 of the payment in gross income for 2004, and the remaining 5/6 of the payment in gross income for 2005.

Example 2. Assume the same facts as in *Example 1*, except that the advance payment is received for a 2-year contract under which up to 96 lessons are provided. *A* provides eight lessons in 2004, 48 lessons in 2005, and 40 lessons in 2006. In its applicable financial statement, *A* recognizes 1/12 of the payment in revenues for 2004, 6/12 of the payment in revenues for 2005, and 5/12 of the payment in gross revenues for 2006. For federal income tax purposes, *A* must include 1/12 of the payment in gross income for 2004, and the remaining 11/12 of the payment in gross income for 2005.

Example 3. On June 1, 2004, *B*, a landscape architecture firm, receives an advance payment for goods and services that, under the terms of the agreement, must be provided by December 2005. On December 31, 2004, *B* estimates that 3/4 of the work under the agreement has been completed. In its applicable financial statement, *B* recognizes 3/4 of the payment in revenues for 2004 and 1/4 of the payment in revenues for 2005. *B* uses the Deferral Method. For federal income tax purposes, *B* must include 3/4 of the payment in gross income for 2004, and the remaining 1/4 of the payment in gross income for 2005, regardless of whether *B* completes the job in 2005.

Example 4. On July 1, 2004, *C*, in the business of selling and repairing television sets, receives an advance payment for a 2-year contract under which *C* agrees to repair or replace, or authorizes a representative to repair or replace, certain parts in the customer's television set if those parts fail to function properly. In its applicable financial statement, *C* recognizes 1/4 of the payment in revenues for 2004, 1/2 of the payment in revenues for 2005, and 1/4 of the payment in revenues for 2006. *C* uses the Deferral Method. For federal income tax purposes, *C* must include 1/4 of the payment in gross income for 2004 and the remaining 3/4 of the payment in gross income for 2005.

Example 5. On December 2, 2004, *D*, in the business of selling and repairing television sets, sells for $200 a television set with a 90-day warranty on parts and labor (for which *D*, rather than the manufacturer, is the obligor). *D* regularly sells televisions sets without the warranty for $188. In its applicable financial statement, *D* allocates $188 of the sales price to the television set and $12 to the 90-day warranty, recognizes 1/3 of the amount allocable to the warranty ($4) in revenues for 2004, and recognizes the remaining 2/3 of the amount allocable to the warranty ($8) in revenues for 2005. *D* uses the Deferral Method. For federal income tax purposes, *D* must include the $4 allocable to the warranty in gross income for 2004 and the remaining $8 allocable to the warranty in gross income for 2005.

Example 6. *E*, in the business of photographic processing, receives advance payments for mailers and certificates that oblige *E* to process photographic film, prints, or other photographic materials returned in the mailer or with the certificate. *E* tracks each of the mailers and certificates with unique identifying numbers. On July 20, 2004, *E* receives payments for 2 mailers. One of the mailers is submitted and processed on September 1, 2004, and the other is submitted and processed on February 1, 2006. In its applicable financial statement, *E* recognizes the payment for the September 1, 2004, processing in revenues for 2004 and the payment for the February 1, 2006, processing in revenues for 2006. *E* uses the Deferral Method. For federal income tax purposes, *E* must include the payment for the September 1, 2004, processing in gross income for 2004 and the payment for the February 1, 2006, processing in gross income for 2005.

Example 7. *F*, a hair styling salon, receives advance payments for gift cards that may later be redeemed at the salon for hair styling services or hair care products at the face value of the gift card. The gift cards look like standard credit cards, and each gift card has a magnetic strip that, in connection with *F*>s computer system, identifies the available balance. The gift cards may not be redeemed for cash, and have no expiration date. In its applicable financial statement, *F* recognizes advance payments for gift cards in revenues when redeemed. *F* is not able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt and therefore does not meet the requirement of section 5.02(1)(b)(i) of this revenue procedure. Further, *F* does not determine under a basis described in section 5.02(3)(b) of this revenue procedure the extent to which payments are earned for the taxable year of receipt. Therefore, *F* may not use the Deferral Method for these advance payments.

Example 8. Assume the same facts as in *Example 7*, except that the gift cards have an expiration date 12 months from the date of sale, *F* does not accept expired gift cards, and *F* recognizes unredeemed gift cards in revenues in its applicable financial statement for the taxable year in which the cards expire. Because *F* tracks the sale date and the expiration date of the gift cards for purposes of its applicable financial statement, *F* is able to determine the extent to which advance payments are recognized in revenues for the taxable year of receipt. Therefore, *F* meets the requirement of section 5.02(1)(b)(i) of this revenue procedure and may use the Deferral Method for these advance payments.

Example 9. *G*, a video arcade operator, receives payments in 2004 for game tokens that are used by customers to play the video games offered by *G*. The tokens cannot be redeemed for cash. The tokens are imprinted with the name of the video arcade, but they are not individually marked for identification. For purposes of its applicable financial statement, *G* completed a study that determined that for payments received for tokens in the current year, *x* percent of tokens are expected to be used in the current year, *y* percent of tokens are expected to be used in the next year, and *z* percent of tokens are expected to never be used. Based on the study, in its applicable financial statement *G* recognizes in revenues for 2004 x percent (tokens expected to be used in 2004) and z percent (tokens expected never to be used) of the payments received in 2004 for tokens; *G* recognizes in revenues for 2005 the remaining *y* percent of the payments received in 2004 for tokens. *G* uses the Deferral Method. Using the study, *G* determines the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt and therefore meets the requirement of section 5.02(1)(b)(i) of this revenue procedure. Under section 5.02(3)(a) of this revenue procedure, *G* must include advance payments in gross income in accordance with its applicable financial statement in the taxable year of receipt, provided that any portion of the payment not included in income in the taxable year of receipt is included in gross income for the next succeeding taxable year. Thus, for federal income tax purposes, *G* must include *x* percent and *z* percent of the advance payments in gross income for 2004, and *y* percent of the advance payments in gross income for 2005.

Example 10. Assume the same facts as in *Example 9*, except that *G* does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure). *G* completed a study on a statistical basis, based on adequate data available to *G*, and concluded that for payments received in the current year, *x* percent of tokens are expected to be used in the current year, *y* percent of tokens are expected to be used in the next year, and the remaining *z* percent of tokens are expected to never be used. Based on the study, *G* treats as earned for 2004 x percent (for tokens expected to be used in that year) as well as *z* percent (for tokens that are expected to never be used). *G* uses the Deferral Method. Using the study, *G* determines the extent to which advance payments are earned in the taxable year of receipt and therefore meets the requirement of section 5.02(1)(b)(ii) of this revenue procedure. Because *G* does not have an applicable financial statement, *G* may determine the extent to which a payment is earned in the taxable year of receipt on a statistical basis under section 5.02(3)(b)(i) of this revenue procedure, provided that any portion that is not included in the taxable year of receipt is included in the next succeeding taxable year. Thus, for federal income tax purposes, *G* must include *x* percent and *z* percent of the advance payments in gross income for 2004, and *y* percent of the advance payments in gross income for 2005.

Example 11. *H* is in the business of compiling and providing business information for a particular industry in an online format accessible over the internet. On September 1, 2004, *H r*eceives an advance payment from a subscriber for 1 year of access to its online database, beginning on that date. In its applicable financial statement, *H* recognizes 1/3 of the payment in revenues for 2004 and the remaining 2/3 in revenues for 2005. *H* uses the Deferral Method. For federal income tax purposes, *H* must include 1/3 of the payment in gross income for 2004 and the remaining 2/3 of the payment in gross income for 2005.

Example 12. On December 1, 2004, *I*, in the business of operating a chain of Ashopping club@ retail stores, receives advance payments for membership fees. Upon payment of the fee, a member is allowed access for a 1-year period to *I*=s stores, which offer discounted merchandise and services. In its applicable financial statement, *I* recognizes 1/12 of the payment in revenues for 2004 and 11/12 of the payment in revenues for 2005. *I* uses the Deferral Method. For federal income tax purposes, *I* must include 1/12 of the payment in gross income for 2004, and the remaining 11/12 of the payment in gross income for 2005.

Example 13. In 2004, *J*, in the business of operating tours, receives payments from customers for a 10-day cruise that will take place in April 2005. Under the agreement, *J* charters a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. In its applicable financial statement, *J* recognizes the payments in revenues for 2005. *J* uses the Deferral Method. For federal income tax purposes, *J* must include the payments in gross income for 2005.

Example 14. On November 1, 2004, *K*, a travel agent, receives payment from a customer for an airline flight that will take place in April 2005. *K* purchases and delivers the airline ticket to the customer on November 14, 2004. *K* retains a portion of the customer's payment (the excess of the customer's payment over the cost of the airline ticket) as its commission. Because *K* is not required to provide any services after the ticket is delivered to the customer, *K* earns its commission when the airline ticket is delivered. The customer may cancel the flight and receive a refund from *K* only to the extent the airline itself provides refunds. *K* does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), but, in its unaudited financial statements, *K* recognizes its commission in revenues for 2005. The commission is not an advance payment as defined in section 4.01 of this revenue procedure because the payment is not earned by *K*, in whole or in part, in a subsequent taxable year. Thus, *K* may not use the Deferral Method for this payment.

Example 15. *L*, a professional sports franchise, is a member of a sports league that enters into contracts with television networks for the right to broadcast games to be played between teams in the league. The money received by the sports league under the contracts is divided equally among the member teams. The league entered into a 3-year broadcasting contract beginning October 1, 2004. *L* receives three equal installment payments on October 1 of each contract year, beginning in 2004. In its applicable financial statement, *L* recognizes 1/4 of the first installment payment in revenues for 2004 and 3/4 in revenues for 2005; *L* recognizes 1/4 of the second installment in revenues for 2005 and 3/4 in revenues for 2006; *L* recognizes 1/4 of the third installment in revenues for 2006 and 3/4 in revenues for 2007. *L* uses the Deferral Method. Under section 4 of this revenue procedure, each installment payment constitutes an Aadvance payment.@ For federal income tax purposes, *L* must include 1/4 of the first installment payment in gross income for 2004 and 3/4 in gross income for 2005; 1/4 of the second installment in gross income for 2005 and 3/4 in gross income for 2006; and 1/4 of the third installment in gross income for 2006 and 3/4 in gross income for 2007.

Example 16. *M* is in the business of negotiating, placing, and servicing insurance coverage and administering claims for insurance companies. On December 1, 2004, *M* enters into a contract with an insurance company to provide property and casualty claims administration services for a 4-year period beginning January 1, 2005. Pursuant to the contract, the insurance company makes four equal annual payments to *M*; each payment relates to a year of service and is made during the month prior to the service year (for example, *M* is paid on December 1, 2004, for the service year beginning January 1, 2005). In its applicable financial statement, *M* recognizes the first payment in revenues for 2005; the second payment in revenues for 2006; the third payment in revenues for 2007; and the fourth payment in revenues for 2008. *M* uses the Deferral Method. Under section 4 of this revenue procedure, each annual payment constitutes an "advance payment." For federal income tax purposes, *M* must include the first payment in gross income for 2005; the second payment in gross income for 2006; the third payment in gross income for 2007; and the fourth payment in gross income for 2008.

Example 17. *N* is a cable internet service provider that enters into contracts with subscribers to provide internet services for a monthly fee (paid prior to the service month). For those subscribers who do not own a compatible modem, *N* provides a rental cable modem for an additional monthly charge (also paid prior to the service month). Pursuant to the contract, *N* will replace or repair the cable modem if it proves defective during the contract period. In December 2004, *N* receives payments from subscribers for January 2005 internet service and cable modem use. In its applicable financial statement, *N* recognizes the entire amount of these payments in revenues for 2005. *N* uses the Deferral Method. Because a subscriber=s use of a cable modem is ancillary to the provision of internet services by *N*, and because the cable modem warranty is ancillary to the use of the cable modem, the payments are advance payments within the meaning of section 4.01(3)(i) of this revenue procedure. Further, because the deferral period for each item is the same in *N*'s applicable financial statement, *N* is not required to allocate the advance payments (see section 5.02(4)(b) of this revenue procedure). For federal income tax purposes, *N* must include the advance payments in gross income for 2005.

Example 18. On January 1, 2005, *O* enters into, and receives advance payments pursuant to, a 5-year license agreement for its computer software. Under the contract, the licensee pays *O* both the first-year (2005) license fee and the fifth-year (2009) license fee upon commencement of the agreement. The fees for the second, third, and fourth years are payable on January 1 of each license year. In its applicable financial statement, *O* recognizes the fees in revenues for the respective license year. *O* uses the Deferral Method. For federal income tax purposes, *O* must include the first-year license fee in gross income for 2005, the second-year and the fifth-year license fee in gross income for 2006, the third-year license fee in gross income for 2007, and the fourth-year license fee in gross income for 2008.

Example 19. On July 1, 2004, *P*, in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support, receives an advance payment for a 2-year Asoftware maintenance contract@ under which *P* will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. In its applicable financial statement, *P* recognizes 1/4 of the payment in revenues for 2004, 1/2 in revenues for 2005, and the remaining 1/4 in revenues for 2006, regardless of when *P* provides updates or customer support. *P* uses the Deferral Method. For federal income tax purposes, *P* must include 1/4 of the payment in gross income for 2004 and 3/4 in gross income for 2005.

Example 20. Assume the same facts as in *Example 19*, except that *P* changes its taxable period to a fiscal year ending March 31 so that *P* has a short taxable year beginning January 1, 2005, and ending March 31, 2005. In its applicable financial statement, *P* recognizes 1/4 of the payment in revenues for the taxable year ending December 31, 2004; 1/8 in revenues for the short taxable year ending March 31, 2005; 1/2 in revenues for the taxable year ending March 31, 2006; and 1/8 in revenues for the taxable year ending March 31, 2007. Because the taxable year ending March 31, 2005, is 92 days or less, section 5.02(2) of this revenue procedure applies. For federal income tax purposes, *P* must include 1/4 of the payment in gross income for the taxable year ending December 31, 2004, 1/8 in gross income for the short taxable year ending March 31, 2005, and the remaining 5/8 in gross income for the taxable year ending March 31, 2006.

Example 21. Assume the same facts as in *Example 19*, except that *P* ceases to exist on December 1, 2004, in a transaction other than a transaction to which ' 381(a) applies. For federal income tax purposes, *P* must include the entire advance payment in gross income for 2004.

Example 22. On July 1, 2004, *Q*, in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support, receives an advance payment of $100 for a 2-year software license agreement that includes a 1-year Asoftware maintenance contract@ under which *Q* will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. In its applicable financial statement, *Q* allocates $20 of the payment to the maintenance contract and $80 to the license agreement, based on objective criteria. With respect to the $20 allocable to the maintenance contract, *Q* recognizes 1/2 ($10) in revenues for 2004 and the remaining 1/2 ($10) in revenues for 2005 regardless of when *Q* provides updates or customer support. With respect to the $80 allocable to the license agreement, *Q* recognizes 1/4 ($20) in revenues for 2004, 1/2 ($40) in revenues for 2005, and the remaining 1/4 ($20) in revenues for 2006. *Q* uses the Deferral Method. For federal income tax purposes, *Q* must include $30 in gross income for 2004 ($10 allocable to the maintenance contract and $20 allocable to the license agreement) and the remaining $70 in gross income for 2005.

SECTION 6. EFFECTIVE DATE

.01 *In General.* Except as provided in section 6.02 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after May 6, 2004.

.02 *Automatic Change for 2003.* For a change in accounting method under section 8.02 or 8.04(1) of this revenue procedure, this revenue procedure is effective for taxable years ending on or after December 31, 2003. See section 8.06 of this revenue procedure for applicable transition rules.

SECTION 7. AUDIT PROTECTION

If a taxpayer uses the Deferral Method described in section 5.02 of this revenue procedure for advance payments (as defined in section 4 of this revenue procedure), the taxpayer's use of the Deferral Method will not be raised as an issue by the Service in a taxable year that ends before May 6, 2004. *But see* sections 9 and 10 of Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432); section 11 of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, as amplified and clarified by Rev. Proc. 2002-54). If the taxpayer uses the Deferral Method described in section 5.02 of this revenue procedure, and the treatment of advance payments (as defined in section 4 of this revenue procedure) under the Deferral Method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, in appeals, or before the U.S. Tax Court in a taxable year that ends before May 6, 2004, that issue will not be further pursued by the Service.

SECTION 8. CHANGE IN METHOD OF ACCOUNTING

.01 *In General.* A change in a taxpayer=s treatment of advance payments to either of the methods described in section 5 of this revenue procedure is a change in method of accounting to which the provisions of ' ' 446 and 481, and the regulations thereunder, apply. A taxpayer may adopt any permissible method of accounting for advance payments for the first taxable year in which the taxpayer receives advance payments. A taxpayer that seeks to change its method of accounting for advance payments must use Form 3115, Application for Change in Accounting Method, and complete all applicable parts thereof. *See* § 1.446-1(e).

.02 *Automatic Change*. Except with respect to a change in method to which section 8.03 or 8.04(2) of this revenue procedure applies, a taxpayer within the scope of this revenue procedure that wants to change to one of the methods of accounting provided in section 5 of this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (or its successor) with the following modifications –

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to change its method for its first or second taxable year ending on or after December 31, 2003, provided the taxpayer=s method of accounting for advance payments is not an issue under consideration for taxable years under examination, within the meaning of section 3.09 of Rev. Proc. 2002-9, at the time the copy of the Form 3115 is filed with the national office;

(2) For purposes of Line 1a of Form 3115, the designated automatic accounting method change number for the changes in accounting method provided in section 5A of the Appendix of Rev. Proc. 2002-9, as added by this revenue procedure, are 83 for changes to the Full Inclusion Method and 84 for changes to the Deferral Method; and

(3) In lieu of providing the information and documentation required by line 1 of Schedule B to Form 3115, a taxpayer changing to the Deferral Method under this section must –

(a) state whether the taxpayer uses an applicable financial statement (as defined in section 4.06 of this revenue procedure) and, if so, identify the type;

(b) describe the basis used for deferral (*i.e.*, the method the taxpayer uses in its applicable financial statement or how the taxpayer determines amounts earned, as applicable); and

(c) if the taxpayer makes an allocation to which section 5.02(4)(c) of this revenue procedure applies, include a statement that the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly provides separately.

.03 *Advance Consent Change*.

(1) A taxpayer within the scope of this revenue procedure that wants to use the Deferral Method for allocable payments described in section 5.02(4)(a) of this revenue procedure (other than allocable payments described in section 5.02(4)(c) of this revenue procedure) or for payments for which a method under section 5.02(3)(b)(i) or (iii) of this

revenue procedure applies must follow the change in method of accounting provisions in Rev. Proc. 97-27.

(2) In lieu of providing the information and documentation required by line 1 of Schedule B to Form 3115, a taxpayer changing to the Deferral Method under this section 8.03 must --

(a) state whether the taxpayer uses an applicable financial statement (as defined in section 4.06 of this revenue procedure) and, if so, identify the type;

(b) describe the basis used for deferral (*i.e.*, the method the taxpayer uses in its applicable financial statement or how the taxpayer determines amounts earned, as applicable);

(c) provide a redacted copy of representative actual contracts or representative sample contracts relating to the advance payments and indicate the particular parts of the contract(s) that are relevant to the requested change;

(d) if the taxpayer makes an allocation to which section 5.02(4)(a) of this revenue procedure applies, include a representation that the claimed allocation is based on objective criteria and a description of the criteria used for the allocation;

(e) if the taxpayer has advance payments to which the method under section 5.02(3)(b)(i) applies, describe the statistical basis used to determine when the advance payments are earned and describe the data and methodology used to develop the statistical basis; and

(f) if the taxpayer has advance payments to which the method under section 5.02(3)(b)(iii) applies, provide an explanation of how the basis used for deferral results in a clear reflection of income.

.04 *Changes to an Overall Accrual Method and the Deferral Method.*

(1) *Automatic change.*

(a) *In general.* This section 8.04(1) applies to a taxpayer that qualifies under section 8.02 of this revenue procedure to change automatically to the Deferral Method and that either --

(i) qualifies under Rev. Proc. 2002-9 to change automatically to an overall accrual method or to an overall accrual method in conjunction with the recurring item exception of § 461(h)(3) (*see* section 5.01(1)(a)(i) or (ii) of the Appendix of Rev. Proc. 2002-9), or

(ii) is required to change to an overall accrual method under § 448 for the first taxable year it is subject to § 448 ("first § 448 year") and otherwise would be required to make the change under the provisions of § 1.448-1(h)(3).

(b) *Application.* A taxpayer described in section 8.04(1)(a) of this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (or its successor) (including all the requirements of section 5.01 of the Appendix of Rev. Proc. 2002-9), with the following modifications --

(i) The taxpayer must file a single Form 3115 for both changes;

(ii) The taxpayer must include both change number 30 and change number 84 on Line 1a of Form 3115;

(iii) The taxpayer must complete all parts of Form 3115 that are applicable to both the change to an overall accrual method and the change to the Deferral Method (see section 8.02(3) of this revenue procedure);

(iv) For changes under section 8.04(1)(a)(i) of this revenue procedure, the taxpayer must complete Schedule A (computation of the § 481(a) adjustment) of Form 3115, including line 1b (income received or reported before it was earned), and must take the net § 481(a) adjustment into account as provided in section 5.04 of Rev. Proc. 2002-9 or section 2.02 of Rev. Proc. 2002-19, as applicable; and

(v) For changes under section 8.04(1)(a)(ii) of this revenue procedure, the taxpayer must complete Schedule A (computation of the § 481(a) adjustment) of Form 3115, including line 1b (income received or reported before it was earned), and must take the net § 481(a) adjustment into account as provided in § 1.448-1(g)(2)(i), (g)(2)(ii), or (g)(3), as applicable.

(2) *Advance consent change.*

(a) *In general.* A taxpayer within the scope of this revenue procedure that wants to change to the Deferral Method under section 8.03 of this revenue procedure, and also wants to change to an overall accrual method or to an overall accrual method in conjunction with the recurring item exception, must request to make both changes by filing one Form 3115, and the taxpayer must follow the change in method of accounting provisions in Rev. Proc. 97-27. Only one user fee is required for these changes. *See* section 5.01(3) of the Appendix of Rev. Proc. 2002-9. The taxpayer must complete all parts of Form 3115 that are applicable to both the change to an overall accrual method and the change to the Deferral Method (see section 8.03(2) of this revenue procedure).

(b) *First § 448 year and Deferral Method change.* A taxpayer within the scope of this revenue procedure that wants to change to the Deferral Method under section 8.03 of this revenue procedure and is required to change to an overall accrual method under § 448 for its first § 448 year must make the change under the provisions of § 1.448-1(h)(3). Only one user fee is required for these changes and the taxpayer must complete all parts of Form 3115 that are applicable to both the change to an overall accrual method and the change to the Deferral Method (see section 8.03(2) of this revenue procedure).

.05 *Previously Filed Forms 3115.* If a taxpayer within the scope of this revenue procedure that qualifies to change its method automatically under section 8.02 or 8.04(1) of this revenue procedure filed a Form 3115 with the national office for a taxable year ending on or after December 31, 2003, and the Form 3115 is pending with the national office on May 6, 2004, the taxpayer must notify the national office in writing prior to July 6, 2004, if the taxpayer wants to withdraw its Form 3115 to make the change under section 8.02 or 8.04(1) of this revenue procedure. If the taxpayer notifies the national office within the time provided in this section 8.05, the taxpayer's Form 3115, and any user fee that was submitted with the Form 3115, will be returned to the taxpayer. A taxpayer whose Form 3115 is returned under this section 8.05 may file a new Form 3115 under the provisions prescribed in section 8.02 or 8.04(1) of this revenue procedure. If the taxpayer does not notify the national office within the time provided in this section 8.05, the national office will continue to process the taxpayer's Form 3115 in accordance with the administrative procedures under which it was originally filed, using existing authority (such as Rev. Proc. 71-21 or § 1.451-5, as applicable). With regard to changes under section 8.04(1) of this revenue procedure, this section 8.05 does not waive the generally applicable scope provisions and other requirements in section 5.01 of the Appendix of Rev. Proc. 2002-9.

.06 *Automatic Change Transition Rule.* A taxpayer within the scope of this revenue procedure that qualifies to change its method automatically under section 8.02 or 8.04(1) of this revenue procedure may change to the Full Inclusion Method, the Deferral Method, or an overall accrual method and the Deferral Method, as applicable, for taxable years ending on or after December 31, 2003. If a taxpayer has timely filed its federal income tax return for its first taxable year ending on or after December 31, 2003, and has not attached a Form 3115 to change its method of accounting for that taxable year to a method provided in this revenue procedure, the taxpayer, as provided in section 6.02(3)(b)(i) of Rev. Proc. 2002-9, is granted an automatic extension of 6 months from the due date of its federal income tax return for the year of change (excluding extensions) to obtain the automatic consent provided by this revenue procedure, provided the taxpayer attaches Form 3115 to an amended return for the year of change and otherwise complies with section 6.02(3)(b)(i) of Rev. Proc. 2002-9.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 71-21 is modified and superseded. Rev. Proc. 2002-9 is modified and amplified to include in section 5 of the Appendix the automatic change provided in section 8.04(1) of this revenue procedure, and to include in section 5A of the Appendix the automatic change provided in section 8.02 of this revenue procedure. The Deferral Method provided in this revenue procedure is available to qualifying taxpayers notwithstanding revenue rulings, revenue procedures, notices, or announcements published by the Service that may provide different rules for when advance payments must be included in gross income. *See, e.g.,* Rev. Rul. 70-445, 1970-2 C.B. 101; Rev. Rul. 68-44, 1968-1 C.B. 191; Rev. Rul. 65-141, 1965-1 C.B. 210; and Rev. Rul. 60-85, 1960-1 C.B. 181.

SECTION 10. DRAFTING INFORMATION

The principal author of this revenue procedure is Edwin B. Cleverdon of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Cleverdon at (202) 622-7900 (not a toll-free call).

Part IV - Items of General Interest

Issuance of Advance Payment Revenue Procedure

Announcement 2004-48

PURPOSE

The Internal Revenue Service has issued Rev. Proc. 2004-34, page **[insert page number on which the rev. proc. begins]** of this Bulletin, which finalizes, with modifications, the revenue procedure proposed in Notice 2002-79, 2002-2 C.B. 964 (the proposed revenue procedure). The purpose of this announcement is to discuss some of the most significant issues raised in connection with finalizing the revenue procedure.

BACKGROUND

Notice 2002-79 proposed a revenue procedure to modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. The proposed revenue procedure provided a limited deferral beyond the taxable year of receipt for certain advance payments for services, certain non-services, and combinations of services and certain non-services. Notice 2002-79 requested comments on the proposed revenue procedure and on the following specific issues:

$ whether the proposed revenue procedure should take into account the cost of goods sold in deferring advance payments from the sale of goods;

$ whether a taxpayer should be permitted to allocate advance payments between the deferral provisions in ' 1.451-5 of the Income Tax Regulations and the proposed revenue procedure;

$ whether advance payments should be accelerated as a result of non-taxable transfers, such as transfers under ' 351 or ' 721 of the Internal Revenue Code, and the treatment of short tax years resulting from ' 381(a) transactions; and

$ whether the use of statistical methodologies for tracing advance payments should be permitted if the taxpayer is unable to determine the extent to which particular advance payments received in a given taxable year are actually included in gross receipts for financial reporting purposes in that year.

The Service received comments on these and several other issues. The most significant comments, along with certain other changes to the proposed revenue procedure, are discussed below.

CHANGES TO THE PROPOSED REVENUE PROCEDURE AND OTHER ISSUES

Allocations

Notice 2002-79 requested comments on allocations of advance payments between the Deferral Method in the proposed revenue procedure and § 1.451-5. Commentators suggested various approaches to resolve allocation issues involving § 1.451-5, including providing deferral rules identical to those provided in the regulations (making the regulations redundant), or making the revenue procedure and regulations mutually exclusive. Commentators also suggested that clarifying the types of services that are integral to a sale of goods for which advance payments may be deferred under § 1.451-5 would eliminate confusion about whether an allocation is necessary.

The Service does not believe it is appropriate to conform the deferral provisions of the revenue procedure to the regulations. Instead, the Service continues to believe it is appropriate to retain for purposes of the revenue procedure the one-year limited deferral rather than to use the longer deferral period allowable under the regulations. In addition, the Service does not believe that the revenue procedure and the regulations should be mutually exclusive. One of the purposes of the revenue procedure is to reduce controversy by allowing a taxpayer to use the revenue procedure without requiring the taxpayer to determine whether the payment qualifies for deferral under the regulations.

The Service recognizes that a taxpayer may receive an advance payment that is partially attributable to an item eligible for the Deferral Method under the revenue procedure and partially attributable to another item, such as: (1) an item that is not eligible for the Deferral Method; (2) an item that is eligible for the Deferral Method, but on a different deferral schedule; or (3) an item that is eligible for deferral under § 1.451-5. In some of these situations, a taxpayer may be able to determine objectively the portion of the advance payment that is eligible for the Deferral Method. In these cases, the Service believes it is appropriate to allow a taxpayer to allocate an advance payment and to apply the Deferral Method to part of the payment and another method of accounting to the rest of the payment. The final revenue procedure, therefore, allows a taxpayer to make allocations if the taxpayer uses objective criteria for the allocation.

A taxpayer that wants to allocate advance payments generally must use the advance consent procedures for a change of accounting method set forth in Rev. Proc. 97-27, 1997-1 C.B. 680, as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, as amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432. However, the final revenue procedure includes a safe harbor allocation for which the taxpayer may use the automatic change of accounting method procedures in Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, and amplified, clarified, and modified by Rev. Proc. 2002-54. Under the safe harbor, if a taxpayer bases the allocation on payments the taxpayer regularly receives for an item or items it regularly provides separately, the allocation will be deemed to be based on objective criteria.

Treatment Of Short Taxable Years

The proposed revenue procedure retained the requirement under Rev. Proc. 71-21 that advance payments be included in gross income by the end of the "next succeeding taxable year" following the taxable year of receipt. Notice 2002-79 requested comments concerning the application of this rule when the next succeeding taxable year is a short taxable year resulting from a § 381 transaction. Commentators suggested various remedies including disregarding short taxable years or providing a minimum fixed deferral period to approximate the limited one-year deferral that would be allowed under the revenue procedure.

The Service agrees that an additional taxable year of deferral should be permitted in the case of certain short taxable years. Therefore, the final revenue procedure provides that, when the next succeeding taxable year is a short taxable year (other than a taxable year in which the taxpayer dies or ceases to exist in a transaction other than a transaction to which § 381(a) applies) of 92 days or less, a taxpayer using the deferral method must include in gross income for the short taxable year the portion of the advance payment recognized for financial reporting purposes (or earned, if applicable) in the short taxable year. Any remaining amount must be included in gross income for the taxable year immediately following the short taxable year.

Acceleration Of Income

The proposed revenue procedure retained the requirement in Rev. Proc. 71-21 regarding the acceleration of inclusion in gross income if the taxpayer dies or ceases to exist (other than in a transaction to which § 381(a) applies) or if the taxpayer's obligation related to the advance payment otherwise ends. The notice requested comments on whether acceleration should be required with respect to certain non-taxable transfers. Several commentators suggested a "step-into-the-shoes" treatment for the transferee, which the Service believes would create significant complexity. Another commentator suggested an exception similar to the exception provided in the method change procedures for § 481(a) adjustments for transfers under § 351 within a consolidated group.

The final revenue procedure incorporates a limited exception for § 351 transfers. A taxpayer will not be required to include the advance payment in gross income if, in a § 351 transaction, (1) substantially all assets of the trade or business (including advance payments) are transferred, (2) the transferee adopts or uses the Deferral Method in the procedure in the year of transfer, and (3) the transferee and the transferor are members of an affiliated group of corporations that file a consolidated return pursuant to §§ 1504 - 1564.

Definition Of "Applicable Financial Statement"

The deferral permitted under the proposed revenue procedure was based on the amount deferred under the taxpayer's method of financial reporting. Commentators expressed concern that, without specific guidelines, taxpayers would adopt financial reporting methods that would maximize deferrals but that might not accurately reflect the true nature of the taxpayer's financial condition. Some commentators recommended adopting a standard based on generally accepted accounting principles (GAAP), and other commentators expressed concern that taxpayers without financial reports would be excluded from using the Deferral Method.

The final revenue procedure adopts an "applicable financial statement" standard similar to that set forth in § 1.56-1(c) regarding the types, and priority, of financial statements. Under the revenue procedure, a taxpayer's applicable financial statement is the first listed of the following:

- Financial statement required to be filed with Securities and Exchange Commission ("SEC") (the 10-K or the Annual Statement to Shareholders);

- Certified audited financial statement used for (in this priority) credit purposes, reporting to shareholders, or other substantial non-tax purposes; and

- Financial statement provided to a government regulator other than the SEC or the Internal Revenue Service.

Thus, for example, a taxpayer that both files a 10-K with the SEC and provides financial statements to a government regulator would be required to use the 10-K as the applicable financial statement under the revenue procedure. For those taxpayers that do not have an applicable financial statement described above, the final revenue procedure provides deferral methodologies based on when the advance payments is earned through performance.

Statistical Sampling

Because the deferral method in the proposed revenue procedure was based exclusively on the taxpayer's financial reporting method, the proposed revenue procedure did not provide an independent method for using a statistical or other basis for determining when an advance payment is earned through performance. Section 3.06 of Rev. Proc. 71-21 provided a rule for using a statistical basis, if adequate data are available to the taxpayer, for determining when services are performed with respect to contingent service agreements. Some commentators were concerned that a similar provision was not included in the proposed revenue procedure.

Because some taxpayers do not have an applicable financial statement as previously described, and because some taxpayers are unable to trace the recognition of individual advance payments in their applicable financial statements, section 5.02(3)(b) of the final revenue procedure was added to allow these taxpayers to use certain other methods, including a statistical basis (if adequate data are available to the taxpayer), to include advance payments in gross income. If a taxpayer seeks to use a statistical basis or other methodology (other than a straight line ratable basis) to determine the amount deferred, the taxpayer must use the advance consent procedures for a change of accounting method set forth in Rev. Proc. 97-27.

Items Not Eligible For Deferral As Advance Payments

Credit Card Fees

The proposed revenue procedure excluded credit card fees from the definition of advance payments. Several commentators requested that credit card fees (including annual fees) be included within the document's scope. The final revenue procedure continues to exclude payments with respect to credit card agreements because the Service has addressed credit card fees in separate guidance. *See* Rev. Rul. 2004-52, page **[insert page number where Rev. Rul. 2004-52 begins]** of this Bulletin, Rev. Proc. 2004-32, page **[insert page number where Rev. Proc. 2004-32 begins]** of this Bulletin, and Rev. Proc. 2004-33, page **[insert page number where Rev. Proc. 2004-33 begins]** of this Bulletin.

Insurance Premiums

The proposed revenue procedure excluded "insurance premiums" from the definition of "advance payments" to avoid conflicts with accounting rules applicable to insurance companies. After further consideration, the Service determined that a more focused definition would be appropriate. Therefore, the final revenue procedure excludes "insurance premiums, to the extent the recognition of those premiums is governed by Subchapter L." This language is intended to exclude insurance companies as well as other entities that recognize income from insurance activities under the subchapter L accounting regime, but not taxpayers that are ineligible for the subchapter L regime (for example, taxpayers that issue insurance contracts but are not insurance companies within the meaning of § 816(a) or § 1.801-3(a)).

Advance Rentals

In conjunction with the final revenue procedure, the Service and Treasury are amending the regulations at § 1.61-8(b) to allow the Service to provide for the deferral of advance rentals. These amendments will be effective retroactively to the date the regulations were proposed in the Federal Register (December 18, 2002). The final revenue procedure applies to advance payments for the use of computer software and intellectual property, which may otherwise be considered advance rentals. Some commentators requested that the revenue procedure be expanded to include advance rentals for tangible property. The Service has not adopted this suggestion. The Service continues to believe that advance rentals for tangible property should be included in gross income when received unless § 467 requires otherwise.

Other Excluded Items

The proposed revenue procedure included payments for warranties in the list of items that may be eligible to be deferred as advance payments. Commentators stated that there could be confusion whether a warranty would be excluded as insurance. In addition to the clarifications made with respect to insurance as discussed above, the Service determined that it was appropriate to exclude warranties and guaranty contracts under which a third party is the primary obligor.

The proposed revenue procedure did not exclude payments in property to which § 83 applies or payments subject to the withholding rules in § 871, 881, 1441, or 1142. Upon further consideration, the Service has determined that because of the specific statutory and regulatory income treatment for transactions under § 83, it is appropriate to exclude payments in property to which § 83 applies from the deferral provisions of the revenue procedure. Additionally, the final revenue procedure excludes payments subject to the specific withholding rules in § 871, 881, 1441, or 1142 from the deferral provisions.

Method Change Issues

The proposed revenue procedure provided that taxpayers would use the automatic change in accounting method procedures in Rev. Proc. 2002-9 to change to either the Deferral Method or the Full Inclusion Method. The Service believes that certain changes permitted under the final revenue procedure raise issues that warrant closer scrutiny by the Service. Therefore, the Service has determined that a taxpayer that wants to change to an accounting method that involves allocations of payments between the Deferral Method in the revenue procedure and some other method generally must follow the advance consent procedures in Rev. Proc. 97-27, rather than the automatic method change procedures. Similarly, a taxpayer that wants to use the Deferral Method, but either does not have an applicable financial statement or does not trace individual advance payments for purposes of its applicable financial statements, must follow the advance consent procedures of Rev. Proc. 97-27 if it wants to defer advance payments on a basis other a straight line ratable basis. The final revenue procedure also provides automatic method change procedures for certain changes to an overall accrual method of accounting combined with a change to the Deferral Method.

Record Keeping

Section 8 of the proposed revenue procedure set forth record keeping rules for taxpayers using an accounting method provided by the revenue procedure. However, because that section did not add to the general record keeping rules applicable to all taxpayers, it was determined that the provision is unnecessary. Thus, although the final revenue procedure does not include this provision, the record keeping rules in § 6001 and the regulations thereunder continue to apply to taxpayers that use a method of accounting provided by the final revenue procedure.

COGS

The proposed revenue procedure did not provide a special rule for cost of goods sold (COGS), but requested comments on whether the revenue procedure should take into account COGS in deferring advance payments from the sale of goods.

Some commentators suggested that the Service does not have the authority to treat advance payments for the sale of goods as income when received, on the theory that the Code and regulations do not allow a tax on gross receipts, and that the Service should *require* taxpayers to defer advance payments for the sale of inventoriable goods.

The revenue procedure does not adopt this recommendation. The long-standing position of the Service has been that advance payments are income when received, unless the taxpayer *elects* to defer under an exception to that general rule. The final revenue procedure is designed to simplify the various issues that have arisen under Rev. Proc. 71-21. After careful consideration, the Service has determined that a special COGS rule is inconsistent with that simplification. Taxpayers that receive advance payments for goods and qualify to use the deferral method in § 1.451-5 may use that method, including the rule for COGS included in the regulation. Taxpayers that use the deferral method provided in the final revenue procedure must use the general rules under § 461 and the regulations thereunder for determining when a liability (including COGS) is incurred.

Effective Date

The revenue procedure is effective for taxable years ending on or after the date of publication. However, a transition rule allows taxpayers who are eligible to use the automatic change provisions to adopt or change to a method provided in the revenue procedure for taxable years ending on or after December 31, 2003.

DRAFTING INFORMATION

The principal author of this announcement is Edwin B. Cleverdon of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this announcement contact Edwin B. Cleverdon on (202) 622-7900 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
JS-1523

Treasury Department Issues Information on May G-7 Meetings

The meeting of the Group of 7 Finance Ministers will take place May 22-23, 2004 at the Waldorf=Astoria Hotel, 301 Park Avenue, New York, NY. The following is a preliminary schedule of events; a final schedule will be released the week of May 17th:

Saturday, May 22

Dinner, Location TBA
Time, TBA
* Pool photo at top of event with pool reporter

Sunday, May 23

G-7 meetings, group photo, and working lunch, Waldorf=Astoria Hotel
8:00 am – mid-afternoon
* Pool coverage for meetings and lunch; national photographers as requested by country
* Group photo is open photo with pool reporter

U.S. press conference, Waldorf=Astoria Hotel
Mid-afternoon
* Open to all media, pre-set time TBA

** There are no bilateral meetings expected at this time.

** The Treasury Department will not issue G-7 accreditation badges to the media. Members of the media should wear the press credentials issued to them by their media organization. Members of the media participating in press pools will be given temporary badges to wear while performing that duty.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 7, 2004
js-1524

The Honorable John W. Snow
Secretary of the Treasury
Prepared Remarks for the Federal Reserve Bank of Chicago
Friday, May 7, 2004

Thank you so much for having me here today.

The resilience and strength of our economy, particularly when given the proper stimulus of tax relief and low interest rates, has been proven once again in recent months.

Our economy has turned the corner, and the path ahead is a long one... a long path of growth of a non-inflationary type. I believe this economy has plenty of room to run without creating inflation.

That said, we know that consumers are facing some jarring prices on everyday purchases. Prices for gasoline, groceries and houses have increased, and they can be a strain on a household budget.

I'm also concerned about the rapid rise in health care costs. It has an enormous impact on our nation's financial future, and this administration is dedicated to finding and implementing ways to control those costs.

Overall, however, I remain extremely optimistic. Prices on some other common consumer purchases have fallen. And while we absolutely must remain sensitive to the daily costs of American's lives, I'm really pleased with our economic health and outlook.

I'm delighted to report, for example, that we've had the best nine months of growth in almost 20 years; GDP has been averaging an outstanding annual rate of 5.5 percent over the last three quarters.

Our economy is on very solid footing, our upward trend is strong, and there can be no doubt that President Bush's leadership on tax cuts made the decisive difference. There can be no doubt that lower marginal income tax rates work.

Yes, investment and hiring were a little delayed this time, but think of what we had to contend with: the horror of 9/11, the high tech bubble bursting, high levels of productivity, as well as the damage done by corporate excesses dating back to the 1990s.

We came back from a low point - and with every bit of good economic news, the spirits of the American people are lifted.

I'd like to add that we can't underestimate how that lifting of spirits positively impacts the economy as well.

We are unique in the world in terms of our ability to rebound. Think about it: Just one year ago, there was a very different economic picture, and some forecasters were pessimistic. You may remember that it was the specter of deflation that was being raised at that point not-so-long-ago.

State budgets were struggling to achieve balance and even those who saw the economy in pretty good shape characterized the recovery as at best wobbly, weak or anemic.

Today, more than half of the states are projecting budget surpluses for this fiscal year. Our economy is running on all four cylinders, thanks in large part to the fact that Americans are keeping more of their hard-earned money - after-tax incomes are up 10 percent since December of 2000 and are substantially above levels following the last recession.

It's great to see that the manufacturing sector is coming back an important job creator. Factory orders increased 4.3 percent in March the biggest increase since July of 2002. The component for durable goods new orders jumped 5 percent in March and the February gain was revised up. A manufacturing activity index signaled expansion in April for the eleventh straight month, remaining near the 20-year high reached in January.

The housing industry remains very strong, with homeownership at an all-time high, and this is something to be very proud of, as a nation. New home sales surged in March, rising 8.9 percent to reach a new record high. Also worth noting, housing starts were up in March, as well as building permits, which are a forward-looking measure of housing activity.

Business spending has rebounded. Business and consumer confidence is up. Consumer confidence increased 4.4 points in April. This means that American households sense that the job market is strengthening.

And now I'd like to talk specifically about the job market. Because jobs are the most important thing any of us who have ever looked for work and couldn't find it for any period of time know this well - and jobs are what follows all of these other indicators that I've just mentioned.

The news on jobs is good. Our economy has created 759,000 jobs in the last seven months... 308,000 in March alone. Layoffs are down, unemployment is down. At 5.7 percent, the unemployment rate remains lower than the average of the 1970s, 80s and 90s, and far below its peak of 6.3 percent in June of 2003. Over the past year, the unemployment rate has fallen in 45 of the 50 states. Initial claims for unemployment insurance have fallen substantially: down 20% over the last year.

I anticipate that this economy will be creating a lot more jobs in the coming months. I'm often asked to make a prediction about how many jobs will be created going forward. I don't know exactly, of course, and I don't make personal predictions or estimates. But what I am confident of, what I do know, is that jobs will follow economic recovery, and jobs will follow economic growth. History tells us that and history will repeat itself today.

So, again, I am optimistic, but I also carry a word of caution: if the President's tax cuts aren't made permanent, the U.S. economy, in our view, will lose its current momentum. The tax relief is the key stimulus for increased capital formation, entrepreneurship and investment that causes sustained, long-term economic growth. And people need to be able to plan if we want them to invest or take risks. Permanency is essential for planning.

The continuation of growth is important to our country, and it is important to the world. It is government's responsibility to ensure the ability of our free-market economy to operate unfettered, lifting the weights that slow it down as much as possible.

We are fortunate to live in a country where freedom allows for great prosperity... and we must never take that for granted, in our daily lives or in our policy decisions.

Thank you for having me here today.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 7, 2004
JS-1525

Statement of Secretary John Snow on the April Employment Report

In the eighth straight month of growth, the economy created 288,000 jobs in April, bringing the total increase since August to more than 1.1 million. The unemployment rate, which is down substantially from its peak last summer, fell in April and is below the average of each of the past three decades.

The longer Americans and American businesses feel the relief of the President's tax cuts, the more the tide of our economy rises. This is apparent in today's jobs report as well as in the reading of GDP growth out last week.

The government must ensure that our free market system is as strong and unfettered as possible. The President's actions to remove weights, like excessive taxation, have provided for needed economic expansion and job growth. But more needs to be done to continue on this upward path. The Administration is committed to reducing lawsuit abuse, ensuring an affordable supply of energy and stemming the rising cost of health care. With the President's leadership, the economy will continue to strengthen and create jobs.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
JS-1526

Treasury Assistant Secretary for Financial Institutions, Wayne A. Abernathy Presented Honorary Certificate of Recognition in Wakefield, Massachusetts to 1st Educational Savings Branch for Efforts in Financial Education to High School Students

Treasury Assistant Secretary for Financial Institutions Wayne Abernathy today presented the 1st Educational Savings Branch (1stESB), Wakefield, MA, with an honorary certificate of recognition for its efforts in teaching financial education to high school students. The 1st ESB is a fully operational bank branch of The Savings Bank operated by students attending Wakefield Memorial High School.

"One of the best ways for students to learn the lessons of financial education is through hands-on experience," said Abernathy. "The opportunity to work in a banking environment at such an early age will undoubtedly benefit these students, both in their careers and in managing their own financial futures."

According to The Savings Bank President/CEO Brian D. McCoubrey, numerous students participating in the program have gone on to work in finance-related fields. "Some students enrolled in the program have worked for The Savings Bank during their senior year and while attending college. Several of the students have been employed by The Savings Bank upon earning degrees," said McCoubrey.

The Savings Bank established the 1stESB in April of 1981, the first of its kind in the country. Each year, five high school seniors are selected to serve as Student Bank Officers. The branch is open one hour and twenty minutes a day to offer services such as checking and savings accounts, certificates of deposit, personal loans, mortgages, and check cashing for faculty and students.

According to Cindy Lyons, the 1stESB Branch Manager, the student officers contribute to the daily decision making process necessary to run a branch office, participate in event and conference planning, offer community service when available, compete in area competitions that include the LifeSmarts Consumer Challenge(tm) sponsored by the National Consumers League, The Stock Market Game Program(tm) (a trademark of the Foundation for Investor Education), and the Massachusetts SMS® Stock Market Simulation. The students also prepare for and attend the Massachusetts School Bankers Associations (MSBA) annual Spring Conference held at the Boston Federal Reserve Bank. The MSBA is an association formed in 1986 to support and advance school banking programs throughout the Commonwealth. At the present time there are 26 high schools in MA with a bank branch on site.

The Savings Bank further supports financial literacy in the public schools through grants from The Donald E. Garrant Foundation, Inc. for projects supporting education in the areas of saving, investing, borrowing, economics and similar financial topics. The Savings Bank also sponsors The CLUB (children learning to understand banking), a bank-at-school program now functioning weekly at eight schools and 104 classrooms. Now in its tenth year of operation, The CLUB has over 1,800 student depositors. The Bank conducts meetings at the bank for CLUB members to discuss saving and to take a tour of the banking facility in order to be exposed to the function and purpose of a bank.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education ("Office") in May 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on, saving, credit management, home ownership and retirement planning. The OFE also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies, and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

30

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
js-1527

Treasury Designates Bosnian Charities Funneling Dollars to Al Qaida

In another step today to halt the flow of terrorist dollars that have tainted the charitable community, the U.S. Department of the Treasury Department designated three Bosnian charities under Executive Order 13224. The U.S. is asking the United Nations' 1267 Sanctions Committee to add these entities to its consolidated list of terrorists tied to al-Qaida, Usama bin Laden and the Taliban.

"Today's action continues the international drumbeat to expose the terrorist nodes used to support the infrastructure of hate," said Juan Zarate, the Treasury Department's Deputy Assistant Secretary for the Executive Office of Terrorist Financing and Financial Crimes. "Unfortunately, we have seen the vulnerabilities of charities in countries like Bosnia, where there is not only a need for charitable giving but also a susceptibility that such institutions will be co-opted by terrorist sympathizers."

The United States previously designated Bosnian-operated charities that were funneling dollars for terrorist-related activities, including the Benevolence International Foundation (BIF), the Global Relief Foundation (GRF) and the Bosnian branch of Al-Haramain Foundation (AHF), including its director and Vazir, an alias for the organization.

Today's action by the Treasury Department designates the following entities:

Al Furqan

Information shows this non-governmental organization had close ties and shared an office with GRF and was chiefly sponsored by the Bosnian branch of AHF. Individuals working for Al Furqan have been involved in multiple instances of suspicious activity, including surveillance of the U.S. Embassy and U.N. buildings in Sarajevo. Although Al Furqan ostensibly ceased operations in 2002, two successor organizations, Sirat and Istikamet, continue to act on behalf of Al Furqan in Bosnia.

A.K.A.s

Dzemilijati Furkan; Dzem'ijjetul Furqan; Association for Citizens Rights and Resistance to Lies; Dzemijetul Furkan; Association of Citizens for the Support of Truth and Suppression of Lies; Sirat; Association for Education, Culture and Building Society-Sirat; Association for Education, Cultural and to Create Society-Sirat; Istikamet; In Siratel.

Addresses

Put Mladih Muslimana 30a
71 000 Sarajevo, BiH

ul. Strossmajerova 72
Zenica, BiH

Muhameda Hadzijahica 42
Sarajevo, BiH

Al-Haramain & Al Masjed Al-Aqsa Charity Foundation

According to information, the Bosnian branch of this entity has significant financial ties to al Qaida financier Wa'el Hamza Julaidan who was designated by the Treasury Department on September 6, 2002. Al-Haramain & Al Masjed Al-Aqsa Charity Foundation also provided financial support to Al Furqan.

A.K.A.s

Al Haramain Al Masjed Al Aqsa; Al Haramayn Al Masjid Al Aqsa; Al-Haramayn and Al Masjid Al Aqsa Charitable Foundation

Address

Hasiba Brankovica No. 2A
Sarajevo, BiH

Taibah International – Bosnia Branch

Information shows this entity has significant ties to GRF, which initially operated in Bosnia under the auspices of Taibah. A former employee of Taibah International was a member of Ayadi Chafiq Bin Muhammad's network, who was designated by the Treasury Department on October 12, 2001.

A.K.A.s

Taibah International Aid Agency; Taibah International Aid Association; Al Taibah, Intl.; Taibah International Aide Association

Addresses

Avde Smajlovic 6
Sarajevo, BiH

26 Tabhanska Street
Visoko, BiH

No. 3 Velika Cilna Ulica
Visoko, BiH

No. 26 Tahbanksa Ulica
Sarajevo, BiH

Executive Order 13224 provides means to disrupt the support network for terrorism. Under this order, the United States government may block the assets of individuals and entities who provide support – financial or otherwise – to designated terrorists and terrorist organizations, who are owned or controlled by designated terrorists, who act for or on the behalf of designated terrorists or who are otherwise associated with designated terrorists. Blocking actions are critical to combating the financing of terrorism.

When a blocking action is put into place, any assets that exist in the U.S. financial system at the time of the orders are frozen, and U.S. persons are prohibited from transacting or dealing with individuals and entities who are the subject of the blocking action. Blocking actions serve additional functions as well, including serving as a deterrent for non-designated parties who might otherwise be willing to finance terrorist activity; exposing terrorist financing "money trails" that may generate leads to previously unknown terrorist cells and financiers; disrupting terrorist financing networks by encouraging designated terrorist supporters to disassociate themselves from terrorist activity and renounce their affiliation with terrorist groups; terminating terrorist cash flows by shutting down the pipelines used to move terrorist-related assets; forcing terrorists to use alternative, more costly and higher-risk means of financing their activities; and engendering international cooperation and compliance with obligations under U.N. Security Council Resolutions.

To date, the U.S. and our international partners have designated 368 individuals and organizations as terrorists and terrorist supporters and have frozen approximately $139 million and seized more than $60 million in terrorist-related assets.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
js-1528

Commission for Assistance to a Free Cuba Releases Initial Report

Snow Commends President Bush's Vision for Hastening the Day Cuba is Free and Democratic

President Bush and the Commission for Assistance to a Free Cuba released an initial report today outlining stepped up measures to choke off dollars funneling into the Castro regime while accelerating the day when Cuba is free.

"This Administration seeks freedom, democracy and prosperity for the Cuban people," said U.S. Treasury Secretary John Snow. "These efforts will tighten the regime's access to capital, hastening the end of Castro's reign and weakening the iron grip he uses to choke-hold and subjugate his people."

Today's report outlined several key efforts to help expedite the day when Castro's dictatorship no longer controls the freedom-hungry people of Cuba, prepare the country for a post-Castro, democratic existence and assist the Cuban people in establishing a free market economy. This framework includes:

à Hastening Cuba's Transition

à Meeting Basic Human Needs in Health, Education, Housing and Human Services

à Establishing Democratic Institutions, Respect for Human Rights, Rule of Law and National Justice and Reconciliation

à Establishing the Core Institutions of a Free Economy

à Modernizing Infrastructure

à Identifying and Addressing Environmental Degradation

The complete report will be available at http://state.gov/p/wha/rt/cuba/.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 7, 2004
js-1529

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. And the Missouri Society of Certified Public Accountants To Team Teach Financial Education Class at Gotsch Elementary, Affton School District in St. Louis, Missouri

Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. will join the Missouri Society of Certified Public Accountants to team-teach a financial education class at Gotsch Elementary, Affton School District in St. Louis, Missouri. While in St. Louis, Deputy Assistant Secretary Iannicola will also present a Certificate of Recognition to the International Institute of St. Louis for providing financial education to refugees and new immigrants.

The Missouri Society of Certified Public Accountants, a statewide association comprised of more than 8,500 CPAs, works with the American Institute of Certified Public Accountants (AICPA) on various financial education efforts.

WHO:	Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr.
WHAT:	Treasury official to team financial education class to 4th graders at Gotsch Elementary.
WHEN:	Monday, May 10, 2004 8:45 a.m. to 10:00 a.m. (CDT) Media Availability
WHERE:	Gotsch Elementary School, Affton School District 8348 S. Laclede Station Rd. St. Louis, MO 63123
Contact:	Missouri Society of Certified Public Accountants Dawn Martin (314) 997-7966

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
JS-1530

Deputy Assistant Secretary Dan Iannicola, Jr.<br>Supports Financial Education Efforts in Louisiana
Through Financial Education Roundtable
And Debt Management Conference in New Orleans

Deputy Assistant Secretary for the Office of Financial Education Dan Iannicola, Jr. today joined a roundtable discussion in New Orleans which focused on financial education initiatives in Louisiana and Mississippi. Educators, financial education advocates, and government officials discussed strategies for promoting and providing financial education to adults and children at the local level. While in New Orleans, Mr. Iannicola also delivered remarks about Treasury's goal of giving all Americans access to financial education at this year's American Association of Debt Management (AADMO) Spring Conference.

"Providing reliable and sound financial education information is crucial to improving people's lives and helping them avoid costly mistakes," said Iannicola. "Thanks to the President's Jobs and Growth Package Americans get to keep more of their own hard earned money. Though innovative financial education programs Americans can learn to manage that money better," Iannicola went on to say.

Various educators and financial education advocates from Louisiana and Mississippi participated in today's roundtable discussion. Participants included Roy Franc Bass, University of New Orleans; Phyllis Cassidy, Good Work Network; Yvonne Ferguson, Bancorp South, Mississippi Jump$tart; Neil Goslin, National Center for the Urban Community, Tulane University; Julie McAdory, Consumer Credit Counseling Services of Greater New Orleans; Nia Richard, Consumer Credit Counseling Services of Greater New Orleans; Diane Puderer, Internal Revenue Service; Inger Richard, Neighborhood Housing Services of New Orleans, Inc.; Jeannette Tucker, Louisiana State University Cooperative Extension Service; Kirk Tucker; Ken Uffman, Credit Bureau of Baton Rouge, Louisiana Jump$tart Coalition; Nancy Montoya, Federal Reserve Bank of Atlanta; and Claire Loupe, Federal Reserve Bank of Atlanta.

AADMO's is the largest trade association in the credit counseling and debt management industry with over 140 members. The organization's stated mission is to provide its members and the public with information about the credit and debt counseling industry. Conference attendees included government officials and AADMO members including, debt management organizations, consumer counselors, personal finance educators, credit and debt information publishers, debt pooling organizations, debt negotiators, debt adjusters, credit counselors, consumer lawyers and more.

The Department of the Treasury is a leader in supporting financial education. Treasury established the Office of Financial Education ("Office") in May 2002. The Office works to promote access to the financial education tools that can help Americans make wiser choices in all areas of personal financial management, with a special emphasis on, saving, credit management, home ownership and retirement planning. The OFE also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies, and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 10, 2004
JS-1531

Treasury Secretary John Snow
Prepared Remarks to Independent Community Bankers
Washington, DC

Thank you so much for having me here today.

It's great to be with a group of lenders who are doing so much for your communities and for our country.

We are in the midst of a strengthening economic recovery, and access to capital for things like homeownership and small business start-ups or expansions is critical. You are playing such an important role in economic growth, and I want to thank you for that.

I know that your communities appreciate your work as well. Your longstanding focus on individual customer relationships and in-depth knowledge of local area credit needs serve your customers well. Of particular importance in achieving major goals set for us by President Bush, your expertise in local area relationship lending enables you to provide financial services to various kinds of small businesses and hard-to-reach customers that might otherwise be overlooked.

And community banks are doing well – according to a recent FDIC study, there were over 1,200 new community banks and thrifts established since the beginning of 1992. After accounting for mergers, acquisitions and only four failures, almost 1,100 of these institutions continue to serve their communities today.

So we see that community banks are thriving, and our economy is thriving, too.

The housing industry is very strong, with homeownership at an all-time high, and this is something to be very proud of, as a nation. New home sales surged in March, rising 8.9 percent to reach a new record high. Also worth noting, housing starts were up in March, as well as building permits, which are a forward-looking measure of housing activity.

I'm really pleased with our overall economic health and outlook.

We had wonderful news on Friday that job growth is very strong. In the eighth straight month of growth, the economy created 288,000 jobs in April, bringing the total increase since August to more than 1.1 million. The unemployment rate, which is down substantially from its peak last summer, fell in April and is below the average of each of the past three decades.

I'm delighted to report that, over the past nine months, we've seen the best growth in almost 20 years; GDP has been averaging an outstanding annual rate of 5.5 percent over the past three quarters.

Business spending has rebounded. Business and consumer confidence is up. Consumer confidence increased 4.4 points in April. This means that American households sense that the job market is strengthening.

One paper today contains the headline, "Higher-Pay Jobs Make a Comeback." The story makes the point that as the U.S. economy grows stronger, the labor market is beginning to create better-paying jobs and that signs point to a turnaround for professional, service and manufacturing work.

It's great to see that the manufacturing sector is coming back, because it's an important source of jobs... and 37,000 manufacturing jobs have been created since February. Factory orders increased 4.3 percent in March – the biggest increase since July of 2002. The component for durable goods new orders jumped 5 percent in March. A manufacturing activity index signaled expansion in April for the eleventh straight month, remaining near the 20-year high reached in January.

The tide of our economy continues to rise, and there can be no doubt that the President's tax cuts made the critical difference.

Another note on jobs: we still need more, and they tend come from the small-business sector... and those are your customers!

That's one of the top reasons why we've got to make the tax cuts permanent... we can't raise taxes on small business at this critical time. They create three out of four net new jobs.

We can also promote job creation by reducing the burdens of abusive lawsuits and rising health-care costs. These stifle growth – again, particularly for small businesses. We've also got to make sure energy is affordable – for businesses and families.

I know you're working with us to keep small business strong, and I appreciate how that helps the economy and every American who needs a job.

You're also working with us to protect people from identity theft, and to protect America from terrorists by identifying and cutting off their blood money.

Last year, we were talking about renewing the Fair Credit Reporting Act... and today we're celebrating it. The work you did to show Congress the importance of our nation's credit reporting system was invaluable.

Thanks to your help on that legislation last year, information to protect consumers can move faster than identity thieves.

FCRA makes our credit market more robust and available for more Americans, for people who had never been able to get a mortgage before, for young people to finance their education, to welcome people into the financial mainstream out of the reach of the loan sharks... so there is much to celebrate about renewing those national standards.

You're protecting your customers against identity thieves, and you're also helping protect America against terrorists. So I want to talk first today about the efforts we are making in partnership to protect America from those who want to harm us.

Out of the horror of September 11 th, 2001, came a tremendous resolve in the financial community to cut off the terrorists' lifeblood: their money.

Institutions large and small have committed themselves to the task.

America's community banks have done everything that the Treasury Department has asked of you during this fight, and I want to personally thank you for your efforts.

Your compliance with Section 314 of the Patriot Act – which requires everyone to share information – has been exemplary.

Under our 314 process, law enforcement provides the names of suspected terrorists or significant money launderers to Treasury's Financial Crimes Enforcement Network (FinCEN), which reviews the names and, if appropriate, sends them on to you. We've asked that you then search your recent account and transaction records for potential matches, and report them back to FinCEN.

You are doing it, and our country is safer because of it.

We understand that the 314 process is an extraordinary tool… it is one that provides law enforcement with valuable leads to follow the money trail. And without your help it would be useless.

We've also asked you to establish risk-based procedures to verify the identity of your customers who open accounts, pursuant to section 326 of the Patriot Act. While we insist that you form a reasonable belief as to the customer's identity, we have also worked hard to ensure that the regulation give you the flexibility to decide which forms of identification works best for you in your communities to verify customer identity. This reflects our judgment that you are in the best position to make such decisions. We believe this flexibility enhances the effectiveness of this regulation.

And we're always looking for ways to provide you with more and better guidance concerning FinCEN's regulations. This is our part of the bargain, our half of the partnership. So let's keep up the dialog… let us know when we're not clear, or when we can do better – because the better our regulations are understood by you, the more successful our critical enforcement efforts will be.

So please know that we appreciate our working relationship on the war on terror, and that we view you as a partner in other critical ways, as well.

You're a partner in economic growth, as I mentioned before.

You are a vital part of two markets that are essential to our continuing economic growth: housing and small business.

As you know, the increase in homeownership and new home construction have been central components in our economic recovery.

And the American system of homeownership is a pillar of our economy, symbolic of our national identity and character, the envy of the world.

That's why it's so very important to have a solid regulatory structure and a credible regulator for the government sponsored entities: Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs). With their important role helping to fund our mortgage markets we need to be sure that they are operating safely, prudently, and efficiently. We also want to ensure that GSEs are living up to the highest standards of corporate responsibility.

The Senate Banking Committee passed GSE reform legislation this year that was lacking in one critical respect: it would have tied the hands of the new regulator if it came to the point where a receivership becomes necessary for a GSE. But, meaningful reform of the housing GSEs remains an important goal of this administration because we want to make sure that your hard work, and your incredible success, is not at risk. Homeownership is too important to all of us to let that happen.

Thank you again for your partnership, for all you do to promote the greatest strengths of the American economy: homeownership and small business.

You are financial heroes, and I appreciate the opportunity to speak with you today.

Thank you – have a great meeting.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

May 10, 2004
JS-1532

Treasury's Iannicola to Award New Market Tax Credit in St. Louis on Tuesday, May 11, 2004

Deputy Assistant Secretary, Dan Iannicola, Jr. will present a $52 million award to the St. Louis Development Corporation, one of the 62 organizations selected by the U.S. Department of the Treasury to receive a total of $3.5 billion in tax credit allocations through the second round of the New Market Tax Credit Program (NMTC), as recently announced by Secretary John W. Snow. The NMTC program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most.

St. Louis Development Corporation is the economic development agency for the city of St. Louis that has formed partnerships to invest in distressed areas of the bi-state St. Louis region.

WHO:
Deputy Assistant Secretary, Dan Iannicola, Jr.

WHAT:
Presenting a New Market Tax Credit award to the St. Louis Development Corporation.

WHEN:
Tuesday, May 11, 2004
10:30 a.m. to 11:00 a.m. CDT

WHERE:
Center for Emerging Technologies
4041 Forest Park Ave.
St. Louis, MO 63108

****Media interested in covering this event should call Treasury's Office of Public Affairs at 202/622-2960**

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2004
JS-1533

Mark J. Warshawsky Assistant Secretary for Economic Policy U.S. Department Of The Treasury Prepared Remarks National Economists Club

Introduction

With the imminent retirement of the Baby Boom generation and rapidly rising health care costs, our country faces a set of challenges in providing retirement security for the coming generation of retirees. I would like to discuss with you today in some detail the challenges we face, and how the Administration is confronting them.

HSAs

Americans have had very little incentive to plan for, or economize on, health spending, yet health care is the biggest financing challenge we face in the long term. Employer-sponsored health plans often provide extensive health insurance coverage. However, employer-sponsored retiree health coverage has been declining. Plus, the Medicare Hospital Trust Fund is now expected to be insolvent in 2019. Consequently, health care cost growth needs to be moderated, and it is more important than ever that individuals play an active role in their own health care decision-making and purchasing.

To help address this problem, Congress passed, and the President signed, the Medicare Modernization Act of 2003, which makes available Health Savings Accounts to a large portion of the population. The legislation allows employers or employees to put money pre-tax into an account of an employee with a high-deductible health plan. These accounts can accumulate interest, and funds can be withdrawn tax-free to pay for qualified health expenditures. The advantages of such an account are many:

- It encourages people to save for periods of unexpectedly high health expenditures, and it is not tied to any one plan or employer and is therefore portable.

- It moves toward giving covered and uncovered health care equitable tax treatment, reducing the incentive for overinsurance and the accompanying moral hazard.

- It makes health spending more transparent, giving consumers the incentive to demand efficiency from providers.

- While health insurance premiums can in general not be paid for with HSA funds, HSAs can be used to pay for COBRA continuation coverage, reducing the likelihood of someone having to drop insurance coverage in the event of job separation.

- The account can be used in retirement to pay for Medicare premiums, out-of-pocket expenses, and employee share of employer-sponsored retirement health care coverage once an individual becomes eligible for Medicare.

Research using data from the RAND Health Insurance Experiment has shown that HSAs could reduce health care expenditures by 4 percent to 8 percent over a traditional indemnity plan.

Now that HSAs are law, both the government and employers have some implementation issues to deal with. Our Office of Tax Policy is now sorting through some of the issues. They released some guidance last month detailing how preventive care benefits may be exempted from the deductible of a high deductible health plan. The guidance also provides transition relief for people to use HSA funds for qualified medical expenses incurred before the establishment of the HSA. They expect to offer further guidance very soon on whether contributions may be made to an HSA while an individual has a Health Reimbursement Account, or HRA, or a Flexible Spending Account, or FSA, and to what extent prior medical expenditures may be reimbursed by an HSA. And in June, they plan to address a host of other questions that people have raised about HSAs and high deductible health plans.

Employers are also confronting implementation issues. For those who offer employees high deductible health plans, they must decide whether they want to contribute to HSAs, how to set the deductibles, and what kind of copayments they will expect of their employees. They also must decide if high-deductible health plans combined with HSAs will compete side-by-side with low-deductible plans giving employees the choice of plans, or whether they will move to exclusively high-deductible plans.

HSAs are an important new choice to people to help control and manage their health care expenditures in the short and long term.

Long-Term Care

There is one other use of HSA funds that I have not mentioned; they may be used to pay long-term care insurance premiums. This is useful, because our society is not prepared to handle the issue of financing care for the elderly disabled. While the incidence of disability is declining, the growth of the population where disability is most prevalent is more than offsetting the decreasing disability rates. Furthermore, like the rest of the health care sector, costs of long-term care services have been rising.

Medicaid spends $46.4 billion on long-term care services for the elderly, a number that has increased by 25 percent since 2000. If per capita LTC cost growth exceeds real GDP growth by 2.5 percent, in other words, stays on the historical growth path of nursing home cost inflation, federal and state Medicaid spending on elderly long-term care will jump from under 0.5 percent of GDP in this year to over 2.5 percent of GDP in 80 years—and that assumes reductions in disability rates continue indefinitely. If that does not sound like a lot to you, think of it this way: total Medicare outlays are not even 2.5 percent today. The details of our calculation are included in an Appendix.

And the recent increase in obesity rates, coupled with many people turning to Medicaid to finance their long-term care needs, mean these projections could understate the financing problem federal and state governments face. Furthermore, some have claimed that people are incorporating Medicaid into long-term retirement and health care planning. This was certainly not the intention of the program's creators. It is therefore an open question whether eligibility rules should be tightened or more strongly enforced, and more generally, how to encourage appropriate long-term planning for long-term care finance.

The Administration would like to encourage people to plan for possible long-term care needs by improving incentives to purchase long-term care insurance. Right now, individuals may deduct qualified long-term care insurance premiums up to certain limits, but only if total medical expenses exceed 7.5 percent of adjusted gross income. The President's 2005 budget requests that individual LTC insurance premiums be fully deductible. Long-term care insurance will undoubtedly play an increasing role in the financial security of Americans, and this policy will help that happen.

Long-term care insurance has been one of my personal research interests for many years. Together with research colleagues Chris Murtaugh and Brenda Spillman, I have been working on developing a concept that would make long-term care insurance more appealing and affordable by combining it with a life annuity. The insurance product would work this way: In return for a single premium, an insurance company would make steady periodic income payments to a retired household (individual or couple), and would increase them substantially when a member of the household is disabled to an extent that would typically cause extra expenses for long-term care to be incurred. Empirical research has shown that, compared to the two components of life annuity and long-term care insurance sold separately, an integrated product can be offered somewhat more cheaply to a larger population that importantly includes people in relatively poor health—individuals who currently cannot purchase any long-term care insurance at any price because they cannot pass through underwriting. These advantages can occur because the product combines two different risk pools into one population.

A particular advantage of this approach, which is timed for those nearing retirement and recently retired, is that it does not demand that households make purchase decisions regarding long-term care insurance early in their life cycle. Early purchase is the alternative approach advocated by some to get around the underwriting problem of long-term care insurance sold at older ages.

It is admitted that the life care annuity cannot serve the needs for long-term care insurance coverage for all populations, especially low-income retired households. Nevertheless, its potential scope is quite large, including households with all types of retirement financial assets, including tax-favored forms, and owner-occupied housing (through reverse mortgages). This innovation could significantly improve the economic security of most retired households, substantially reduce dependence on the public means-tested Medicaid welfare and Medicare insurance programs, and encourage further product innovations. Several variations are possible in product design, both in the nature of provision of long-term care benefits and in the income annuity benefits, and in the level of benefits provided. In particular, the product can be designed to fit into state Medicaid partnership programs.

But there are still a few steps that need to be taken before this product can become marketable. With my colleagues in the Treasury's Office of Tax Policy, I am exploring the different tax treatments of the product. There are several open issues, depending on how such a policy is structured, that is, whether it is structured as two separate products for tax purposes, or whether it is treated as an annuity for tax purposes. Legislative and regulatory changes may be required to ensure such a product is legal and taxed appropriately. Furthermore, insurance companies may want more experience or protections, such as participating policies, before they commit themselves to selling long-term care-related policies in which the entire premium is paid for upfront.

LSAs and RSAs

The Administration is also examining ways to better encourage saving for retirement and other long-term needs. The current system of IRAs and Roth IRAs is very complex, subject to rules regarding eligibility, contributions, tax treatment, and withdrawal. The list of non-retirement exceptions within IRAs, which is expanding, weakens the focus on retirement saving. The restrictions on withdrawals for certain purposes discourage individuals from contributing to these accounts, afraid that they will not have funds to cover unpredictable expenses. The President has asked Congress to consolidate the different types of IRAs into one account dedicated solely for retirement, and to create a new account that would encourage saving, but could also be used for any expenses a taxpayer wanted.

Retirement Savings Accounts, or RSAs, would be dedicated solely to retirement savings. Individuals would be able to contribute $5,000 per year, indexed to inflation. In contrast to the current set of IRAs, there would be no income limits on contributions. Like Roth IRAs, contributions would not be tax deductible, but earnings would accumulate tax-free and qualified distributions would be excluded from gross income. Existing IRAs would be rolled over to RSAs.

Like with RSAs, individuals could also contribute up to $5,000 annually to a Lifetime Savings Account, or LSA. Contributions to LSAs would also have to be in cash, they would be nondeductible, yet earnings would accumulate tax-free. But unlike with RSAs, *any* distributions would be excluded from gross income, regardless of the individual's age or use of the distribution. Thus, there are no mandates on use of funds. However, because the LSA accumulates earnings tax-free, individuals would have a strong incentive to leave funds in the account.

By simplifying and enhancing the tax preferences for savings, people will take advantage of the incentives to plan for short- and long-term needs.

Social Security

Any discussion involving financing retirement must touch on the issue of Social Security. The recently released Social Security Trustees Report shows once again that the program, as currently structured, is unsustainable. However, the problem of financing Social Security is fixable. The President has issued three guiding principles for reforming Social Security:

The program should protect seniors, meaning that retirees and near-retirees should not face a cut in benefits.

- Personal retirement accounts should be made available, to give individuals different options to plan for their retirement.

- Reforms should make the program permanently sustainable, so we do not have to revisit this topic repeatedly, making generation after generation fear that their retirement will not be funded as promised.

If we keep these sensible principles in mind as we work through reform proposals, we should be able to find a solution that will guarantee many generations a secure retirement.

Fundamental Pension Reform and Measurement Improvements

1. Introduction

I would like to spend the bulk of my discussion here talking about needed reforms to the private pension system. We all want to improve the retirement security for the nation's workers and retirees by strengthening the financial health of the voluntary defined benefit system that they rely upon. We believe that with improvements, the DB system will continue to be a viable and important part of the American retirement system.
I will discuss the Administration's proposals and ongoing activities aimed at strengthening the long-term health of the defined benefit pension system and thereby improving the retirement security of defined benefit pension participants. I don't think it will come as a surprise to anyone that I, the Treasury Department and the Administration all believe the ERISA rules can be improved.

What might surprise some of you is that we are actively engaged in developing a proposal for comprehensive reform of the system. While we are not ready to unveil a fully formed proposal for comprehensive reform of the pension funding rules, I can discuss some of the areas we are studying and provide what I believe are important guiding principles for the process.

2. Facts

Some basic facts about the DB system and PBGC's financial health suggest that we need to be concerned about the current set of funding rules:

- PBGC's single employer plan ended 2003 with a record deficit of $11.2 billion. This deficit is the result of two consecutive years of staggering net losses. Net loss for 2002 was $11.2 billion. Net loss for 2003 was $7.6 billion.

- PBGC's multiemployer program reported a year end deficit of $261 million. This is the first deficit in more than 20 years and the largest ever.

- In 2003 PBGC absorbed 152 terminated single-employer plans covering 206,000 participants.

- Including multi-employer plans, at year-end, PBGC was responsible for the pensions of more than 930,000 people.

- PBGC's single employer plan continues to face significant exposure from troubled companies with underfunded plans, particularly in the air transportation and steel sectors. PBGC estimates that total underfunding in single-employer plans exceeded $350 billion as of the fiscal year-end. Underfunding in multi-employer plans is estimated at $100 billion.

- This is not a transitory problem: PBGC uses stochastic modeling to evaluate its exposure and expected claims. The results of this modeling are quite sobering. The distribution of PBGC's potential 2013 financial position has a median deficit of $18.7 billion. There is only a 19 percent probability of a surplus of any amount – and an equal probability of deficits exceeding $32 billion.

3. Administration's Proposal to Improve the Accuracy and Transparency of Pension Information

Before discussing comprehensive reform, I would like to briefly discuss the proposals that the Administration has already put forward in this area. In July 2003, we released the Administration's Proposal to Improve the Accuracy and Transparency of Pension Information. This proposal was designed to strengthen and secure Americans' pension security by:

- Improving the accuracy of the pension liability discount rate;

- Increasing the transparency of pension plan information; and

Strengthening safeguards against pension underfunding.

We have been disappointed that Congress has not acted on the majority of the proposals we put forward.

The proposal that has generated the most discussion and debate is our proposal to use a yield curve based on high-quality corporate bonds to discount pension liabilities and smoothed over 90 days for the purpose of computing current liability.

To determine minimum required funding contributions, a plan sponsor must compute the present value of the plan participants' accrued future benefit payments, which is known as the plan's current liability. The present value of a benefit payment due during a particular future year is calculated by applying a discount factor to the dollar amount of that payment. This discount factor converts the dollar value of the future payment to today's dollars. Current liability is simply the sum of all these discounted future payments.

Pension liabilities must be accurately measured to ensure that pension plans are adequately funded to protect workers' and retirees' benefits and to ensure that minimum funding rules do not impose unnecessary financial burdens on plan sponsors. Liability estimates that are too low will lead to plan underfunding, potentially undermining benefit security. Pension plan liability estimates that are too high lead to higher than necessary minimum contributions, reducing the likelihood that sponsors will continue to operate defined benefit plans.

Choosing the right rate is the key to accurate pension discounting. The wrong rate leads to inaccurate estimates of liabilities that can be either too high or too low. Therefore, the primary goal of the Administration's proposal to replace the 30-year Treasury rate can be summed up in one word: accuracy.

Each pension plan has a unique schedule of future benefit payments - or cash flow profile that depends on the characteristics of the work force covered by the plan. In general, plans with more retirees and older workers, more lump sum payments, and shrinking workforces will make a higher percentage of their pension payments in the near future, while plans with younger workers, fewer retirees, fewer lump sums, and growing workforces will make a higher percentage of payments in later years.

Current liability computation rule apply the same discount rate to all future payments regardless of when they occur. This approach produces inaccurate liability estimates because it ignores a basic reality of financial markets: that the rate of interest earned on an investment or paid on a loan varies with the length of time of the investment on the loan. If a consumer goes to a bank to buy a

Certificate of Deposit, he will expect to receive a higher rate on a five-year CD than on a one-year CD. Likewise, that same consumer who borrows money to buy a house expects to pay a higher interest rate for a 30-year than a 15-year mortgage.

Pension discount rates must recognize this simple financial reality which is the main thrust of our proposal.

Beyond the discount rate, there were two other reform tasks that the Administration recommended for immediate attention.

· First, the transparency of information pertaining to pension plan funding needs to be increased.

o We propose requiring that each year sponsors disclose to participants the value of their defined benefit pension plan assets and liabilities measured on both a current liability and a termination liability basis.

o In addition, we proposed that certain financial data already collected by the PBGC from companies sponsoring pension plans with more than $50 million of underfunding should be made public.

· Second, the Administration proposed to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. When firms with below investment grade credit ratings increase pension benefit promises, the costs of these added benefits stand a good chance of being passed on to the pension insurance system, frustrating the benefit expectations of workers and retirees and penalizing employers who have adequately funded their plans.

o Under the Administration's proposal, if a plan sponsored by a firm with a below investment grade credit rating has a funding ratio below 50 percent of termination liability, benefit improvements would be prohibited, the plan would be frozen (no accruals resulting from additional service, age or salary growth), and lump sum payments would be prohibited unless the employer contributes cash or provides security to fully fund these added benefits.

o When a plan sponsor files for bankruptcy the PBGC's guarantee limits would also be frozen.

We felt this was a constructive, forward looking set of proposals that would have helped ensure PBGC and plan solvency in the short-term, while setting the table for more fundamental reforms.

4. Fundamental Reform

Making Americans' pensions more secure is a big job that will require comprehensive reform of the pension system. Americans have a broadly shared interest in adequate funding of employer-provided defined benefit pensions. Without adequate funding, the retirement income of America's workers will be insecure. This by itself is a powerful reason to pursue improvements in our pension system. At the same time, we must always be mindful that the defined benefit pension system is voluntary. Firms offer defined benefit pensions to their workers as an employee benefit, as a form of compensation. Our pension rules should thus be structured in ways that encourage, rather than discourage, employer participation.

Key aspects of the current system frustrate participating employers while also failing to produce adequate funding. We thus have multiple incentives to improve our pension system, and to thus better ensure both the availability and the viability of worker pensions. We have begun the hard work needed to create a system that more clearly and effectively funds pension benefits. We will develop a pension system that will be less complex, more flexible, logically consistent, and will achieve the goal of improving the security of defined benefit plans.

While the Administration continues to consider comprehensive reform measures, I'd like to discuss some of the goals for reform/principles that underpin my thinking about reform and discuss the major areas of pension law that I believe require our prompt attention. First some starting principles for a reform proposal that:

- **Current regime has failed to ensure adequate plan funding.** Current defined benefit (DB) pension funding rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The rules attempt to ensure adequate funding by micromanaging plan behavior.

- **Funding rules should focus on outcomes not process.** The government has an interest in defining a minimum prudent funding level and maximum tax deductible funding. Many other funding decisions are best left to plan sponsors. Sponsors of adequately funded plans should be given maximum flexibility. Sponsors of minimally or underfunded plans should be required to take timely corrective actions.

- **A successful proposal will center on the use of real incentives to motivate desired behavior and frees responsible plans from burdensome regulation.**

It may be clear to some of you that I am suggesting a real overhaul of the ERISA rules may be necessary. Let's discuss some general areas of concern that we are studying.

1. Funding Targets

We will seek to develop better, more economically meaningful, funding targets.

Asset Measurement. Under existing rules, assets can be measured as multi-year averages rather than current values. Pension funding levels can only be set appropriately if both asset and liability measures are current and accurate. Failure to accurately measure assets and liabilities contributes to funding volatility. *Liability Measurement.* We also intend to examine how the application of actuarial assumptions in the current rules may contribute to funding volatility and to inaccurate measurement of pension liabilities. We will examine:

a. Retirement Assumptions. Retirement assumptions made by plan actuaries need to reflect the actual retirement behavior of those covered by the plan.

b. Lump Sums. Liability computations for minimum funding purposes need to include reasonable estimates of expected future lump sum withdrawals that are determined by methodologies that are broadly consistent with other estimates of plan obligations.

c. Mortality. Treasury is in the process of updating mortality assumptions.

2. Funding Path

The current system of funding rules and asset and liability measurement has been constructed, in part, to dampen the volatility of firms' funding contributions. Yet current rules fail to do so. After years of making few or no contributions at all, many firms are facing precipitous increases in their annual funding requirements. This outcome is frustrating to business and it has failed to provide adequate funding for workers and retirees. Improvements to funding rules should mitigate volatility, provide firms with the ability to make more consistent contributions, and increase flexibility for firms to fund up their plans in good times. Specific issues in the funding rules that need to be examined include:

a. Contribution Deductibility. Together, minimum funding rules and limits on maximum deductible contributions require sponsors to manage their funds within a narrow range. Raising the limits on deductible contributions would allow sponsors to build larger surpluses to provide a better cushion for bad times.

b. Credit Balances. If a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest can be credited against future required contributions. These credit balances mere accounting entries - do not fall in value even if the assets that back them lose value. Credit balances allow seriously underfunded plans to avoid making contributions, often for years, and contribute to funding volatility.

c. Volatility Caused by the Minimum Funding Backstop. The current minimum funding backstop, known as the deficit reduction contribution, causes minimum contributions of underfunded plans to be excessively volatile from year to year.

d. New Benefit Restrictions. The current Administration proposal is to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. We are looking at areas where it may be appropriate to expand this proposal.

e. Benefit Amortization. The amortization period for new benefits can be up to 30 years long. This may be excessive. We will also look at other statutorily defined amortization periods.

3. Other Issues

a. Extent of Benefit Coverage. It may be advisable to limit or eliminate guarantees of certain benefits that typically are not funded, such as shutdown benefits.

b. Multi-employer Plan Problems. Multi-employer plans operate under a different set of rules than single-employer plans. Despite these regulatory differences, the same principles of accuracy and transparency should apply to multi-employer plans, and we will be reviewing the best ways to accomplish this.

c. PBGC Premiums. PBGC's premium structure should be re-examined to see whether it can better reflect the risk posed by various plans to the pension system as a whole.

Conclusion

To briefly conclude, we have mounting challenges facing us with our system of financing retiree health care, long-term care, and pensions. Waiting to deal with these problems until they become a crisis will sharply limit our options. Because we know these problems will only get worse, it is imperative that we commit ourselves to addressing them now. I believe the policies I have mentioned today shows the Administration is committed to addressing these challenges.

Appendix:

The aging U.S. population will create increasing demand for long-term care services.

- Medicaid is an important source of financing for both institutional and home-based long-term care. For instance, Medicaid funds 49 percent of aggregate nursing home expenditures.

The CBO projects that in 2004, Medicaid will spend $46.4 billion on long-term care for the elderly, an increase of 25 percent since 2000.

Even though incidence of disability is declining, price inflation and demographic changes are likely to increase the federal burden, through the Medicaid program, of financing long-term care.

- Assuming a continuation of historical rates of decline in disability, as well as historical cost inflation of long-term care services, Medicaid financing of long-term care for the elderly will amount to 2.5 percent of GDP in 2082, up from 0.4 percent of GDP today. This would make it larger, as a share of the economy, then the entire Medicare program today.

· This projected growth rate could understate what will actually occur. Actual growth rates will exceed GDP plus 2.5 percentage points if (1) people increasingly structure their finances so as to rely on Medicaid for long-term care needs; (2) the obesity epidemic increases disability incidence; or (3) the reduction in fertility rates leads to increasing reliance on professional services for long-term care.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 10, 2004
JS-1534

Treasury Announces the Appointment of Art Garcia to Serve As Director of the Community Development Financial Institutions Fund

Secretary of the Treasury, John W. Snow today announced the appointment of Arthur A. Garcia to serve as Director of Treasury's Community Development Financial Institutions Fund.

As Director of the CDFI Fund, Mr. Garcia will oversee the expansion of access to capital and financial services in critically under-served urban, rural and Native American communities, where one of the biggest obstacles to economic development is a lack of access to mainstream sources of private sector capital.

"The Community Development Financial Institution Fund plays an important role in the Bush's Administration's efforts to encourage economic growth and job creation in every corner of this nation. Art Garcia's experience and knowledge will be a great asset as we continue to pursue these goals," stated Assistant Secretary for Financial Institutions, Wayne A. Abernathy.

Mr. Garcia has served as the Administrator of the Rural Housing Service (RHS) at the U.S. Department of Agriculture since April 2002. Prior to coming to Washington D.C., Mr. Garcia served on the faculty of both Webster University and the University of Phoenix and the College of Santa Fe.

In addition, Mr. Garcia was a Lender Manager with Sunwest Bank, and he also served as Vice President of retail banking at First State Bank in New Mexico. Mr. Garcia has served as President of the Hispanic Bankers Association.

Mr. Garcia is a graduate of New Mexico State University and the School of Banking at the University of New Mexico. He also received a Masters Degree in Finance and a Masters of Business Administration from Webster University.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 11, 2004
JS-1535

Treasury Clarifies Interaction Of Health Savings Accounts With Other Employer-Provided Health Reimbursement Plans

Today Treasury and the IRS issued Revenue Ruling 2004-45 which clarifies how health Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs) interact with Health Savings Accounts (HSAs). The guidance provides a number of ways that individuals may have access to benefits from FSAs and HRAs and remain eligible to contribute to an HSA.

"Although the statute does not permit individuals to contribute to an HSA while being covered by general purpose health FSAs and HRAs, the guidance provides significant flexibility to employers in structuring health reimbursements for employees," stated Greg Jenner, Acting Assistant Secretary for Tax Policy. In particular, the ruling states that eligible individuals (who must be covered by a high deductible health plan (HDHP)) may continue to contribute to an HSA while also covered by the following types of employer-provided plans that reimburse employee medical expenses:

- Limited purpose FSAs and HRAs that restrict reimbursements to certain permitted benefits such as vision, dental, or preventive care benefits.
- Suspended HRAs where the employee has elected to forgo health reimbursements for the coverage period.
- Post-deductible FSAs or HRAs that only provide reimbursements after the minimum annual deductible has been satisfied.
- Retirement HRAs that only provide reimbursements after an employee retires.

"We believe that the ability of employers to allow employees to temporarily suspend reimbursements from HRAs so they can contribute to an HSA without forfeiting accumulated HRA benefits provides important transitional relief for employers adopting high deductible health plans with HSAs," said Mr. Jenner.

The guidance also provides that combinations of these arrangements may also be provided without disqualifying an individual from contributing to an HSA. In addition, the ruling clarifies that individuals with coverage by an FSA and an HRA, as well as an HSA, may reimburse expenses through the FSA or HRA prior to taking distributions from the HSA, as long the individual does not seek multiple tax-favored reimbursements for the same expense.

REPORTS

- Revenue Ruling 2004-45

Section 223 - Health Savings Accounts—Interaction with Other Health Arrangements

Rev. Rul. 2004-45

ISSUE

In the situations described below, may an individual make contributions to a Health Savings Account (HSA) under section 223 of the Internal Revenue Code if the individual is covered by a high deductible health plan (HDHP) and also covered by a health flexible spending arrangement (health FSA) or a health reimbursement arrangement (HRA)?

FACTS

Situation 1. An individual is covered by an HDHP (as defined under section 223(c)(2)(A)). The HDHP has an 80/20 percent coinsurance feature above the deductible. The individual is also covered by a health FSA under a section 125 cafeteria plan and an HRA that meets the requirements of Notice 2002-45, 2002-2 C.B. 93. The health FSA and HRA pay or reimburse all section 213(d) medical expenses that are not covered by the HDHP (such as co-payments, coinsurance, expenses not covered due to the deductible and other medical expenses not covered by the HDHP). The health FSA and HRA coordinate the payment of benefits under the ordering rules of Notice 2002-45. The individual is not entitled to benefits under Medicare and may not be claimed as a dependent on another person's tax return.

Situation 2. Same facts as Situation 1, except that the health FSA and HRA are limited-purpose arrangements that pay or reimburse, pursuant to the written plan document, only vision and dental expenses (whether or not the minimum annual deductible of the HDHP has been satisfied). In addition, the health FSA and HRA pay or reimburse preventive care benefits as described in Notice 2004-23, 2004-15 I.R.B. 725.

Situation 3. Same facts as Situation 1, except that the individual is not covered by a health FSA. Under the employer's HRA, the individual elects, before the beginning of the HRA coverage period, to forgo the payment or reimbursement of medical expenses incurred during that coverage period. The decision to forgo the payment or reimbursement of medical expenses does not apply to permitted insurance, permitted coverage and preventive care ("excepted medical expenses"). See section 223(c)(1)(B) and Notice 2004-23. Medical expenses incurred during the suspended HRA coverage period (other than the excepted medical expenses if otherwise allowed to be paid or reimbursed by an HRA), cannot be paid or reimbursed by the HRA currently or later (i.e., after the HRA suspension ends). However, the employer decides to continue to make employer contributions to the HRA during the suspension period and thus the maximum available amount under the HRA is not affected by the suspension but is available for the payment or reimbursement ofthe excepted medical expenses incurred during the suspension period as well as medical expenses incurred in later HRA coverage periods.

Situation 4. Same facts as Situation 1, except that the health FSA and HRA are post-deductible arrangements that only pay or reimburse medical expenses (including the individual's 20 percent coinsurance responsibility for expenses above the deductible) after the minimum annual deductible of the HDHP has been satisfied.

Situation 5. Same facts as Situation 1, except that the individual is not covered by a health FSA. The employer's HRA is a retirement HRA that only reimburses those medical expenses incurred after the individual retires.

LAW AND ANALYSIS

Section 223(a) allows a deduction for contributions to an HSA for an "eligible individual" for any month during the taxable year. Section 223(c)(1)(A) provides that an "eligible individual" means, with respect to any month, any individual who is covered under an HDHP on the first day of such month and is not, while covered under an HDHP, "covered under any health plan which is not a high deductible health plan, and which provides coverage for any benefit which is covered under the high deductible health plan."

Section 223(b) provides a limit on amounts that can be contributed to an HSA. The maximum annual contribution limit for an eligible individual with self-only coverage is the amount required by section 223(b)(2)(A). The maximum annual contribution limit for an eligible individual with family coverage is the amount required by section 223(b)(2)(B).

Section 223(c)(2)(A) defines an HDHP as a health plan that satisfies certain requirements with respect to minimum annual deductibles and maximum annual out-of-pocket expenses. Generally, if substantially all of the coverage in a health plan that is intended to be an HDHP is provided through a health FSA or HRA, the health plan is not an HDHP.

In addition to coverage under an HDHP, section 223(c)(1)(B) provides that an eligible individual may have specifically enumerated coverage that is disregarded for purposes of the deductible. Coverage that may be disregarded includes "permitted insurance" and other specified coverage ("permitted coverage"). "Permitted insurance" is coverage under which substantially all of the coverage provided relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property, insurance for a specified disease or illness, and insurance that pays a fixed amount per day (or other period) of hospitalization. "Permitted coverage" (whether through insurance or otherwise) is coverage for accidents, disability, dental care, vision care or long-term care. Section 223(c)(2)(C) also provides a safe harbor for the absence of a preventive care deductible. See Notice 2004-23.

The legislative history of section 223 explains these provisions by stating that "eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan." The legislative history also explains that, "[a]n individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage." H.R. Conf. Rep. No. 391, 108th Cong., 1st Sess. 841 (2003).

Section 125(a) states that no amount will be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Section 125(d) defines a cafeteria plan as a written plan under which participants may choose among two or more benefits consisting of cash and qualified benefits.

Section 125(f) defines qualified benefits as any benefit not included in the gross income of the employee by reason of an express provision in the Code. Qualified benefits include employer-provided accident and health coverage under section 106, including health FSAs.

Notice 2002-45, 2002-2 C.B. 93, describes the tax treatment of HRAs. The notice explains that an HRA that receives tax-favored treatment is an arrangement that is paid for solely by the employer and not pursuant to a salary reduction election under section 125, reimburses the employee for medical care expenses incurred by the employee and by the employee's spouse and dependents, and provides reimbursement up to a maximum dollar amount with any unused portion of that amount at the end of the coverage period carried forward to subsequent coverage periods.

Notice 2002-45, Part IV, states that if an employer provides an HRA in conjunction with another accident or health plan and that other plan is provided pursuant to a salary reduction election under a cafeteria plan, then all the facts and circumstances are considered in determining whether the salary reduction is attributable to the HRA. An accident or health plan funded pursuant to salary reduction is not an HRA and is subject to the rules under section 125.

Under section 223, an eligible individual cannot be covered by a health plan that is not an HDHP unless that health plan provides permitted insurance, permitted coverage or preventive care. A health FSA and an HRA are health plans and constitute other coverage under section 223(c)(1)(A)(ii). Consequently, an individual who is covered by an HDHP and a health FSA or HRA that pays or reimburses section 213(d) medical expenses is generally not an eligible individual for the purpose of making contributions to an HSA. See Rev. Rul. 2004-38, 2004-15 I.R.B. 717, which holds that an individual who is covered by an HDHP that does not provide prescription drug coverage and a separate prescription drug plan or rider that provides benefits before the minimum annual deductible of the HDHP has been satisfied is not an eligible individual for HSA purposes.

However, an individual is an eligible individual for the purpose of making contributions to an HSA for periods the individual is covered under the following arrangements:

Limited-Purpose Health FSA or HRA. A limited-purpose health FSA that pays or reimburses benefits for "permitted coverage" (but not through insurance or for long-term care services) and a limited-purpose HRA that pays or reimburses benefits for "permitted insurance" (for a specific disease or illness or that provides a fixed amount per day (or other period) of hospitalization) or "permitted coverage" (but not for long-term care services). In addition, the limited-purpose health FSA or HRA may pay or reimburse preventive care benefits. The individual is an eligible individual for the purpose of making contributions to an HSA because these benefits may be provided whether or not the HDHP deductible has been satisfied.

Suspended HRA. A suspended HRA, pursuant to an election made before the beginning of the HRA coverage period, that does not pay or reimburse, at any time, any medical expense incurred during the suspension period except preventive care, permitted insurance and permitted coverage (if otherwise allowed to be paid or reimbursed by the HRA). The individual is an eligible individual for the purpose of making contributions to an HSA. When the suspension period ends, the individual is no longer an eligible individual because the individual is again entitled to receive payment or reimbursement of section 213(d) medical expenses from the HRA. An individual who does not forgo the payment or reimbursement of medical expenses incurred during an HRA coverage period, is not an eligible individual for HSA purposes during that HRA coverage period.

If an HSA is funded through salary reduction under a cafeteria plan during the suspension period, the terms of the salary reduction election must indicate that the salary reduction is used only to pay for the HSA offered in conjunction with the HRA and not to pay for the HRA itself. Thus, the mere fact that an individual participates in an HSA funded pursuant to a salary reduction election does not necessarily result in attributing the salary reduction to the HRA.

Post-Deductible Health FSA or HRA. A post-deductible health FSA or HRA that does not pay or reimburse any medical expense incurred before the minimum annual deductible under section 223(c)(2)(A)(i) is satisfied. The individual is an eligible individual for the purpose of making contributions to the HSA. The deductible for the HRA or health FSA ("other coverage") need not be the same as the deductible for the HDHP, but in no event may the HDHP or other coverage provide benefits before the minimum annual deductible under section 223(c)(2)(A)(i) is satisfied. Where the HDHP and the other coverage do not have identical deductibles, contributions to the HSA are limited to the lower of the deductibles. In addition, although the deductibles of the HDHP and the other coverage may be satisfied independently by separate expenses, no benefits may be paid before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied.

Retirement HRA. A retirement HRA that pays or reimburses only those medical expenses incurred after retirement (and no expenses incurred before retirement). In this case, the individual is an eligible individual for the purpose of making contributions to the HSA before retirement but loses eligibility for coverage periods when the retirement HRA may pay or reimburse section 213(d) medical expenses. Thus, after retirement, the individual is no longer an eligible individual for the purpose of the HSA.

In the arrangements described, the individual does not fail to be an eligible individual under section 223 and may contribute to an HSA. In addition, combinations of these arrangements which are consistent with these requirements would not disqualify an individual from being an eligible individual.

For example, if an employer offers a combined post-deductible health FSA and a limited-purpose health FSA, this would not disqualify an otherwise eligible individual from contributing to an HSA.

An individual may not be reimbursed for the same medical expense by more than one plan or arrangement. However, if the individual has available an HSA, a health FSA and an HRA that pay or reimburse the same medical expense, the health FSA or the HRA may pay or reimburse the medical expense, subject to the ordering rules in Notice 2002-45, Part V, so long as the individual certifies to the employer that the expense has not been reimbursed and that the individual will not seek reimbursement under any other plan or arrangement covering that expense (including the HSA).

HOLDINGS

In Situation 1, the individual is covered by an HDHP and by a health FSA and HRA that pay or reimburse medical expenses incurred before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. The health FSA and HRA pay or reimburse medical expenses that are not limited to the exceptions for permitted insurance, permitted coverage or preventive care. As a result, the individual is not an eligible individual for the purpose of making contributions to an HSA. This result is the same if the individual is covered by a health FSA or HRA sponsored by the employer of the individual's spouse. See, Rev. Rul. 2004-38.

In Situation 2, the individual is covered by an HDHP and by a health FSA and HRA that pay or reimburse medical expenses incurred before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. However, the medical expenses paid or reimbursed by the health FSA and HRA include only vision and dental benefits (which are permitted coverage) and preventive care. All of these benefits may be covered as a separate health plan, as a separate or optional rider, or as part of the HDHP and whether or not the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. The individual is an eligible individual for the purpose of making contributions to an HSA.

In Situation 3, the individual elects to forgo the payment or reimbursement of medical expenses incurred during an HRA coverage period. The suspension of payments and reimbursements by the HRA does not apply to permitted insurance, permitted coverage and preventive care (if otherwise allowed to be paid or reimbursed by the HRA). The individual is an eligible individual for the purpose of making contributions to an HSA until the suspension period ends and the individual is again entitled to receive, from the HRA, payments or reimbursements of section 213(d) medical expenses incurred after the suspension period.

In Situation 4, the health FSA and HRA pay or reimburse medical expenses (including the 20 percent coinsurance not otherwise covered by the HDHP) only after the HDHP's minimum annual deductible has been satisfied. The individual is an eligible individual for the purpose of making contributions to an HSA.

In Situation 5, the HRA is a retirement HRA that only pays or reimburses medical expenses incurred after the individual retires. The individual is an eligible individual for the purpose of making contributions to an HSA before retirement because the HRA will pay or reimburse only medical expenses incurred after retirement.

DRAFTING INFORMATION

The principal author of this notice is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Tanner on (202) 622-6080 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
JS-1536

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. Today Presented $52 Million New Market Tax Credit Award to St. Louis Development Corporation in St. Louis, Missouri

Deputy Assistant Secretary, Dan Iannicola, Jr. today presented a $52 million award to the St. Louis Development Corporation, one of the 62 organizations selected by the U.S. Department of the Treasury to receive a total of $3.5 billion in tax credit allocations through the second round of the New Market Tax Credit Program (NMTC), as recently announced by Secretary John W. Snow. St. Louis Development Corporation is the economic development agency for the city of St. Louis that has formed partnerships to invest in distressed areas of the bi-state St. Louis region.

"President Bush's support of the New Market Tax Credit awards demonstrates a clear commitment to provide renewed economic opportunity and prosperity, especially to many hard-hit areas," said Iannicola."

The NMTC program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most. The program was established by Congress in December 2000, and permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The credit provided to the investor totals 39 percent of the initial value of the investment and is claimed over a seven-year credit allowance period.

St. Louis Development Center anticipates using the NMTC allocation to attract capital for business lending, equity investments in emerging business operations, patient capital for site assembly, gap financing for real estate development, and major project funding. The NMTC financing will offer nontraditional rates and terms, which will be targeted to highly distressed areas of the St. Louis region.

The NMTC Program is administered by Treasury's Community Development Financial Institutions (CDFI) Fund. The CDFI anticipates that applications for the third round of the NMTC Program will be available during the summer of 2004.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
JS-1537

Remarks Of Treasury Deputy Assistant Secretary Dan Iannicola Jr., To Award A $52 Million New Market Tax Credit Award In St. Louis, Missouri

It is great to be here with all of you

Today is a great day for St. Louis. It is a great day for me, too. Because as a native St. Louisan I am just as happy to present these tax credits to Mayor Slay as he is to receive them.

Having been here for most of the last 30 plus years I've had a chance, like you, to see the past efforts to redevelop the area. We've seen the struggles and the triumphs, experienced hopes and the disappointment.

But lately it seems that more projects than usual are coming together and that the redevelopment efforts are really paying off.

And I believe a big part of this new trend is that is that the entire region has reached the conclusion that when it comes to the future of this area, the city is not just important, it's essential.

The St. Louis Metropolitan Area will never be better nor worse than its urban core.

For with it, goes the fate of the region. It is, both literally and figuratively, at the center of everything.

We've always known that, today we're doing something about it.

So whether you're from Ellisville or Edwardsville or whether you're from St. Peter's or Arnold today's announcement is good news.

And for those waiting for St. Louis to finally realize its promising future, we have an announcement to make: the future is now.

With exciting re-development projects taking place along Washington Avenue,

in mid-town, at the new ball park site, and in many historic neighborhoods, St. Louis is on the move.

No one can deny that momentum is growing or that this city's efforts are reaching critical mass.

And Secretary Snow and the Department of Treasury are pleased to be part of St. Louis' urban renewal. The New Markets Tax Credit is an important tool for community and economic development. Two of the reasons the tax credit program works is because it brings in private sector funds and because it permits flexibility at the local level.

Private sector involvement is key. The goal of the tax credit is to attract capital from these private sources. That's because private sector money can make a strong impact on a community and can lead to the type of sustainable growth that will create a positive ripple throughout a neighborhood.

Allowing flexibility at the local level is also important. Because when it comes to issues like community development, decisions should be made, not by distant regulators, but by local decision-makers.

The people in this room today, more than anyone else, know how best to help their communities.

They know, by name and by need, the projects that will have the biggest impact on St. Louisans and their region. Tying local control to this local knowledge base is an essential part of the program.

The main idea behind the New Markets Tax Credit, and President's support of it, is that private industry working with local community organizations can bring development, can bring prosperity, can bring hope to every neighborhood, in every zip code in every city.

The tax credits we present today will encourage job creation and business investment in communities that need it most. It is part of President Bush's vision for a vibrant, growing economy that provides opportunity for all who seek it.

And that's why I'm here today. To congratulate you on this accomplishment,

To encourage you to continue your aggressive efforts in job creation and community redevelopment

And to help you tell the world that St. Louis is a great place to live, to work, to invest and to do business.

Thank you.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
JS-1538

Treasury Designates Commercial Bank of Syria as Financial Institution of Primary Money Laundering Concern

311 Action Comes on the Heels of President Bush's Declaration of National Emergency With Respect to Syria

The U.S. Department of the Treasury today designated the Commercial Bank of Syria (CBS), along with its subsidiary Syrian Lebanese Commercial Bank, as a financial institution of "primary money laundering concern," pursuant to Section 311 of the *USA PATRIOT Act*.

"Todaywe areusing the authority granted by Congress under Section 311 of the *PATRIOT Act* to help protect theU.S. financial system against rogue financial institutions," saidJuan Zarate, the Treasury Department's Deputy Assistant Secretary for the Executive Office for Terrorist Financing and Financial Crimes. "Thefinancial communityaround the worldis now on notice that thisbankpresents a risk oftainted financial activity thatmust be addressed."

Information garnered shows CBS had been used by terrorists and their sympathizers and acted as a conduit for the laundering of proceeds generated from the illicit sale of Iraqi oil. Specifically more than $1 billion was illegally diverted by Saddam Hussein's regime from the U.N.'s Oil for Food (OFF) program, and some of these proceeds flowed through accounts at CBS.

The Government of Syria also has not taken steps to transfer the CBS accounts containing the proceeds generated from the illicit sale of Iraqi oil to the Development Fund for Iraq (DFI), as required under U.N. Security Council Resolution (UNSCR) 1483. Finally, numerous transactions that may be indicative of terrorist financing and money laundering have been transferred through CBS, includingtwoaccounts at CBS thatreferencea reputed financier for Usama bin Laden.

In conjunction with this designation, Treasury is sending to the Federal Register a notice of proposed rulemaking that would prohibit any U.S. bank, broker-dealer, futures commission merchant, introducing broker or mutual fund from opening or maintaining a correspondent account for or on behalf of CBS. Correspondent accounts involving CBS would have to be terminated without exception. This special measure, which is the most severe measure that can be imposed through Section 311, may be imposed only through the issuance of a regulation.

CBS, based in Damascus, Syria, maintains approximately 50 branches and employs about 4,500 persons. CBS was established in Syria in 1967 as the single, government-owned bank specializing in servicing foreign trade and commercial banking, including foreign exchange transactions. CBS maintains correspondent accounts with banks in countries all over the world, including the United States. CBS has one subsidiary, Syrian Lebanese Commercial Bank, located in Beirut, Lebanon, of which CBS maintains approximately an 84 percent ownership interest. Syrian Lebanese Commercial Bank has two branches and two offices – its main branch in Beirut, a branch in Moussaitbeh and representative offices in Aleppo and Damascus, Syria. Syrian Lebanese Commercial Bank also maintains correspondent accounts with a few banks in the United States.

Title III of the *PATRIOT Act* amends the anti-money laundering provisions of the *Bank Secrecy Act* (BSA) to promote the prevention, detection and prosecution of international money laundering and the financing of terrorism. Section 311 authorizes the Secretary of the Treasury – in consultation with DOJ, the State Department and appropriate Federal financial regulators – to designate a foreign jurisdiction, institution, class of transactions or type of account to be of "primary money laundering concern" and to require U.S. financial institutions to take certain "special measures" against the designee.

These special measures range from enhanced recordkeeping or reporting obligations to a requirement to terminate correspondent banking relationships with the designated entity. The measures are meant to provide Treasury with a range of options to most effectively target specific money laundering and terrorist financing

In additional action against Syria today, President George W. Bush signed an Executive Order declaring a national emergency with respect to Syria, authorizing the Department of the Treasury to block the property of certain persons and directing other U.S. Government agencies to impose a ban on exports to Syria.

This action is in response to the Syrian government's continued support of international terrorism, sustained occupation of Lebanon, pursuit of weapons of mass destruction and missile programs and undermining of U.S. and international efforts in Iraq. Syria's acts threaten the national security, foreign policy and economy of the United States.

The sanctions are imposed under the *International Emergency Economic Powers Act (IEEPA)*, the *National Emergencies Act,* the *Syria Accountability and Lebanese Sovereignty Restoration Act of 2003* (SAA) and the United States Code.

Today's executive order imposes the following sanctions on Syria:

- Authorizesthe U.S. Department of the Treasury to designateindividuals and entities contributing totheGovernment of Syria's problematic behavior. This action would subject designees tosanctions that willblock their property and property interestsand prohibit U.S. persons fromengaging in financial transactions withthem.
- Prohibits exports and reexports to Syria of most goods, excluding food and medicine. The export ban will primarily be implemented by the U.S. Department of Commerce, which will license the export of limited categories of goods pursuant to the President's exercising of partial waivers of the SAA.
- Prohibits commercial air services between the United States and Syria by Syria-owned and controlled aircraft. Certain non-traffic stops by such aircraft are also prohibited. The flight ban will be implemented by the U.S. Department of Transportation.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
JS-1539

Testimony of Daniel L. Glaser Director, Executive Office For Terrorist Financing and Financial Crime U.S. Department of the Treasury Before the House Government Reform Subcommittee on Criminal Justice, Drug Policy and Human Resources

As you will hear from this panel — and as we and the Department of Justice re-affirmed in our publication of the *National Money Laundering Strategy of 2003* (*2003 Strategy*) last fall — the campaign against terrorist financing and money laundering forms an essential component of our national security strategy. Since September 11th, we have leveraged the relationships, resources, authorities, and expertise that we have acquired over the past several years in combating money laundering to attack terrorist financing. Our efforts in both arenas are complementary and are effecting the changes required to protect the integrity of our financial systems by identifying, disrupting and dismantling sources, flows, and uses of tainted capital within those systems.

I. Treasury's Role in Combating Financial Crime

Sanctions and Administrative Powers: Treasury wields a broad range of powerful economic sanctions and administrative powers to attack various forms of financial crime. We have continued to use these authorities in the campaign against terrorist financing, drug trafficking, money laundering and other criminal financial activity.

- In combating terrorism financing, the U.S. government's primary and most public tool is the ability of the Departments of the Treasury and State to designate terrorist financiers and terrorists under Executive Order (E.O.) 13224, together with Treasury's ability to implement orders that freeze the assets of terrorists under E.O. 13224.

- In combating drug trafficking, Treasury continues to apply its authorities under the Foreign Narcotics Kingpin Designation Act and the International Emergency Economic Powers Act (IEEPA) to administer and enforce the provisions of law relating to the identification and sanctioning of major foreign narcotics traffickers.

- In combating money laundering, Treasury has applied its new authority under Section 311 of the USA PATRIOT Act ("Patriot Act") to designate and take action against jurisdictions and financial institutions of primary money laundering concern.

Financial Regulation and Supervision: The Treasury Department – through FinCEN's administration of the Bank Secrecy Act as amended by Title III of the Patriot Act – is responsible for establishing the U.S. AML/CFT regime by issuing the regulations intended to safeguard U.S. financial institutions from abuse by terrorists, narcotics traffickers, and other organized criminals. Treasury further maintains close contact with the federal financial supervisors – including the Treasury Department's Office of the Comptroller of the Currency and Office of Thrift Supervision – to ensure that these regulations are being implemented throughout the financial sectors.

Private Sector Outreach: As a result of our traditional role in safeguarding the financial system, Treasury has developed a unique partnership with the private sector that provides us with the benefits of the insights and suggestions of the financial institutions that are in many ways the front-line in our war against money laundering and terrorist financing. Through such mechanisms as the Bank Secrecy

Act Advisory Group, Treasury ensures that the private sector plays an appropriate role in the development of AML/CFT regulatory policy and receives appropriate feedback from the information it provides.

TFI will enhance the Treasury Department's ability to meet our own mission and to work cooperatively with our partners in the law enforcement and intelligence communities. The Department of the Treasury is committed to complementing, but not duplicating, the important work being done by the Department of Justice and Department of Homeland Security, and by the various intelligence agencies, and will be fully integrated into already established task forces and processes.

This is why we are committed to "targeting the money" from a systemic approach. We believe that resources devoted to fighting money laundering and financial crimes through a systemic approach reap benefits far beyond merely addressing the underlying financial crimes they directly target. When applied on a systemic basis, targeting the money can identify and attack all kinds of activity, including the financing of terrorism, narcotics trafficking, securities fraud, alien smuggling, organized crime, and public corruption. Financial investigations lead to those who are committing the underlying financial crimes, as well as to those financial professionals who facilitate the criminal activity.

The terrorism we are fighting generally operates through complex networks. In this context, a terrorist act, no matter how basic and inexpensive, cannot be accomplished without a sophisticated financial and operational infrastructure. Terrorist organizations such as al Qaida and Hamas require a financial and operational infrastructure. They must pay for the security of "safe havens," financial support for the families of "martyrs," recruitment, indoctrination, logistical support, and personnel training. This doesn't even get into the costs of ostensibly humanitarian efforts – charitable organizations, medical clinics and schools – that are either created as fronts for terrorism or to win support and recruits. Finally, there is the cost of weapons. In short, the horrific results of terrorism require the raising, movement and use of considerable funds. The terrorist leaves identifiable and traceable footprints in the global financial systems, and these footprints must be pursued "downstream" to identify future perpetrators and facilitators, and "upstream" to identify funding sources and to dismantle supporting entities and individuals.

The U.S. Government has led an international coalition to disrupt, dismantle, and destroy the sources and pipelines from and through which terrorists receive money. Under Executive Order 13224, we have designated a total of 361 individuals and entities, as well as frozen or seized approximately $200 million of terrorist-related funds worldwide. The impact of these actions goes beyond the amount of money frozen. Public designation and asset blocking choke off terrorist cash flows by cutting off access to the U.S. and other financial systems and also provide access to further intelligence. Designations under E.O. 13224 in the past year include the following:

- Ten al Qaida loyalists related to the Armed Islamic Group (GIA) on March 18
- Shaykh Abd Al-Zindani (al Qaida-related) on February 24, 2004
- Four branches of the Al Haramain Islamic Foundation (al Qaida-related) on January 22, 2004);
- Abu Ghaith (al Qaida-related) on January 16, 2004;
- Dawood Ibrahim (al Qaida-related) on October 17, 2003;
- Al Akhtar Trust International (al Qaida-related) on October 14, 2003;
- Abu Musa'ab Al-Zarqawi (al Qaida-related) on September 24, 2003;
- Yassin Sywal, Mukhlis Yunos, Imam Samudra, Huda bin Abdul Haq, Parlindungan Siregar, Julkipli Salamuddin, Aris Munandar, Fathur Rohman A1-Ghozi, Agus Dwikarna, and Abdul Hakim Murad (members of Jemaah Islamiyah) on September 5, 2003;

- Sheik Ahmed Yassin (Gaza), Imad Khalil Al-Alami (Syria), Usama Hamdan (Lebanon), Khalid Mishaal (Syria), Musa Abu Marzouk (Syna), and Abdel Aziz Rantisi (Gaza) (Hamas political leaders) on August 22, 2003;

- Comité de Bienfaisance et de Secours aux Palestiniens (France), Association de Secours Palestinien (Switzerland), Interpal (UK), Palestinian Association in Austria, and the Sanibil Association for Relief and Development (Lebanon) (all Hamas-related charities) on August 22, 2003;

- The National Council of Resistance of Iran (including its U.S. representative office and all other offices worldwide) and the People's Mujahedin Organization of Iran (including its U.S. press office and all other offices worldwide) on August 15, 2003;

- Shamil Basayev (al Qaida-related) on August 8, 2003; and

- The Al-Aqsa International Foundation (Hamas-related) on May 29, 2003.

Together with the State and Justice Departments and other agencies, we are following-up on these designations by using our diplomatic resources and regional and multilateral engagements to ensure international cooperation, collaboration and capability in designating these and other terrorist-related parties through the United Nations and around the world.

- Important financial networks – such as those of al Barakaat and parts of the Al Haramain Islamic Foundation – have been identified and shut down at home and abroad. The UAE and Somalia-based al Barakaat network had been used to funnel potentially millions of dollars annually to al Qaida and its affiliates.

- We have worked with counterparts in important allies such as Saudi Arabia to ensure that key terrorist financiers and facilitators have had their assets frozen and/or have been arrested or otherwise addressed through the international community's concerted law enforcement efforts. Included in this category are Saudi millionaires Yasin al-Qadi and Wa'el Hamza Julaidan, Swift Sword, and Bin Laden's Yemeni spiritual advisor, Shaykh Abd- Al-Zindani,

- The U.S. has also taken significant actions against non-al Qaida linked terrorist organizations such as HAMAS and the Basque terrorist group, ETA. On December 4, 2001, President Bush issued an order to freeze the assets of a U.S.-based foundation – The Holy Land Foundation for Relief and Development – along with two other HAMAS financiers, Beit al Mal and the Al Aqsa Islamic Bank. Six leaders of Hamas and six charities in Europe and the Middle East that support Hamas were subsequently designated in May and August 2003. In partnership with our EU allies, the U.S. designated 31 ETA operatives and one organization that supports ETA.

- FinCEN has made 342 proactive case referrals to law enforcement potentially involving terrorism based upon analysis of information in the Bank Secrecy Act database. The Terror Hotline established by FinCEN has resulted in 853 tips passed on to law enforcement since 9/11. FinCEN is also implementing an Electronic Reports program that will further enhance law enforcement's ability to utilize this information. Additionally, with the expansion of the Suspicious Activity Report (SAR) regime, as of April 28, 2004, financial institutions nationwide have filed 4,294 SARs reporting possible terrorist financing directly to FinCEN, including1,866 SARS in which terrorist financing represented a primary suspicion. This has further enhanced our efforts to identify and vigorously investigate terrorist financing webs and dismantle them.

- We have developed the use of technology to identify possible sources of terrorist financing, particularly through the pilot counterterrorism project undertaken by IRS-CI in Garden City, New York. The Garden City Counterterrorism Lead Development Center is dedicated to providing research and nationwide project support to IRS-CI and the Joint Terrorism Task Force (JTTF) counterterrorism financing investigations. Relying on modern technology, the Center is comprised of a staff of IRS Special

Agents, Intelligence Analysts, and civil components from the Service's Tax Exempt/Government Entities Operating Division, who will research leads and field office inquiries concerning terrorism investigations. Center personnel specializing in terrorism issues will develop case knowledge, identify trends, and provide comprehensive data reports to IRS field agents assigned to JTTFs or to those conducting CI counterterrorism financing investigations. The Center may also serve to de-conflict related investigations among multiple field offices, and will have distinctive analytical capabilities to include link analysis, data matching, and pro-active data modeling. Using data from tax-exempt organizations and other tax-related information that is protected by strict disclosure laws, the Center will analyze information not available to or captured by other law enforcement agencies. Thus, a complete analysis of all financial data will be performed by the Center and disseminated for further investigation. This research, technology, and intuitive modeling, coupled with CI's financial expertise, are maximizing IRS-CI's impact against sophisticated terrorist organizations.

- The U.S. has identified 24 countries as priorities for receiving counter-terrorist financing technical assistance and training, and we are working bilaterally to deliver such assistance to these priority countries. The U.S. is also working together with its allies in the Counter-Terrorism Action Group (CTAG) and the Financial Action Task Force (FATF) to coordinate bilateral and international technical assistance efforts to additional priority countries in the campaign against terrorist financing.

- The U.S. has enlisted the active support of international bodies, such as the G-7, G-10, G-20, the Asia-Pacific Economic Cooperation Forum (APEC), and others — to make efforts against terrorist financing a priority for their members. The G7, G20, APEC, Western Hemisphere Finance Ministers (WHFM), ASEAN Regional Forum (ARF), and OSCE have all issued action plans calling on their members to take a series of concrete measures to enhance the effectiveness of their counter-terrorist financing regimes.

- Our systemic efforts and targeted designations, together with USG law enforcement, diplomatic, intelligence and military actions, have deterred potential terrorist supporters and sympathizers by increasing the cost and the risk of doing business with terrorists.

B. Drug Trafficking

Treasury, in conjunction with the Departments of Justice, State and Homeland Security, enforces the IEEPA narcotics sanctions against Colombian drug cartels under Executive Order 12978. The objectives of the Specially Designated Narcotics Traffickers (SDNT) program are to identify, expose, isolate and incapacitate the businesses and agents of certain specified Colombian drug cartels and to deny them access to the U.S. financial system and to the benefits of trade and transactions involving U.S. businesses and individuals. Targets are identified in consultation with the Drug Enforcement Administration and the Narcotics and Dangerous Drug Section of the Department of Justice. Since the inception of the SDNT program in October 1995, 956 parties have been identified as SDNTs, consisting of 14 Colombian drug cartel leaders, 381 businesses and 561 other individuals.

Treasury also implements the President's sanctions under the Foreign Narcotics Kingpin Designation Act ("Kingpin Act"). The Kingpin Act, enacted in December 1999, operates on a global scale and authorizes the President to deny significant foreign narcotics traffickers, and their related businesses and operatives, access to the U.S. financial system and all trade and transactions involving U.S. companies and individuals. During 2003, the President named seven new kingpins, including two designated foreign terrorist organizations -- Revolutionary Armed Forces of Colombia and United Self-Defense Forces of Colombia -- and a Burmese narco-trafficking ethnic guerilla army, bringing the total number designated to 38.

Another weapon that the U.S. uses against narco-traffickers and money launderers is seizure and confiscation. In fiscal year 2003, Treasury's Executive Office for Asset Forfeiture (TEOAF) received over $ 234 million in forfeiture revenue from the combined efforts of the former Bureau of Alcohol, Tobacco Firearms and Explosives, the U.S. Secret Service (USSS), the Internal Revenue Service (IRS), and the former U.S. Customs Service (USCS). This represents a significant increase over fiscal year 2002, in which TEOAF received over $152 million of forfeiture revenue. This improvement is particularly impressive when considering the transition undertaken by three of these law enforcement bureaus in the government reorganization last year.

III. Enhancing Interagency Coordination

Despite considerable progress achieved, several important challenges remain in the campaign against terrorist financing and money laundering. We have identified a number of priorities to advance our long-term and short-term goals as described above and in the *2003 Strategy.*

In addition to setting standards, we are facilitating compliance with existing international standards through terrorist financing technical assistance to priority countries, both bilaterally and through a coordinated international effort. Internationally, we anticipate completing technical needs assessments of priority countries through the FATF within the next few months. Thereafter, we will work with the State Department in coordinating the delivery of appropriate assistance to these countries through the CTAG. Bilaterally, we will continue to work with the State Department and the interagency community to ensure that those countries targeted for bilateral assistance receive it as planned.

Another priority is engaging the Middle East as a priority in promoting greater transparency and understanding of regional financial systems and regional money laundering and terrorist financing threats. We are working with the World Bank, other organizations and states, and the countries in the region to facilitate development of a FATF-style regional body for the Middle East and North Africa, and anticipate the launch of this organization by the end of 2004. In addition, we are participating in a number of ongoing training and outreach seminars with government officials in the region on anti-money laundering and counter-terrorist financing issues, including in the United Arab Emirates and Lebanon, and are exploring the continued study of terrorist financing and drug trafficking connections with countries in that region.

To exploit these existing and developing transparencies, we must also advance our short-term strategy by enhancing our ability to identify, disrupt and dismantle terrorist and criminal organizations. We are pursuing a number of priorities, both domestically and internationally, to advance this goal.

Internationally, we are focusing our efforts on achieving greater European cooperation and support for our terrorist financing designations. We are capitalizing on our progress in improving and clarifying international standards for freezing terrorist-related assets under FATF Special Recommendation III by: (i) pursuing bilateral and multilateral efforts to reform the EU Clearinghouse process, and (ii) encouraging national implementation of UN member state obligations under United Nations' Security Council Resolution 1373.

I will be happy to answer any questions you may have.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
js-1540

Treasury Secretary Snow Statement on Senate Passage of FSC/ETI Legislation

I would like to thank the Senate for taking action to move the FSC/ETI process forward to avoid sanctions. Passing the FSC/ETI legislation is an important step toward ending the burden of the tariffs currently being imposed on U.S. exports under the WTO sanctions. We will continue our efforts to work with Congress to ensure that legislation is signed into law that will help us comply with our WTO obligations, is as close to budget neutral as possible, and will strengthen our economy and help manufacturers and other job creators. We want to increase the ability of American companies to succeed in a worldwide economy and lay the foundation for increased growth and job creation for American workers.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2004
js-1541

Treasury Department Names Kimberly Reed as Senior Advisor to the Secretary

The Treasury Department today announced that Kimberly A. Reed, Esq. has been appointed as Senior Advisor to the Secretary. She began her new post this week, and brings extensive experience to the position.

As the Senior Advisor to the Secretary, Ms. Reed will provide advice to the Secretary of the Treasury and the Chief of Staff on issues pertaining to both policy and departmental operations.

Ms. Reed most recently served as Professional Staff for the U.S. House of Representatives' Committee on Ways and Means Oversight Subcommittee. She has worked for the U.S. House for most of her career, also holding positions as Counsel to the Committee on Government Reform and, prior to that, as Counsel to the Committee on Education and the Workforce Oversight and Investigations Subcommittee.

Ms. Reed received a dual Bachelor's degree in Biology and Government from West Virginia Wesleyan College, and a Juris Doctor's degree from West Virginia University College of Law. She originally is from Buckhannon, WV.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2004
js-1542

Oklahoma Makes Federal Health Coverage Tax Credit Available

Today, Treasury Secretary John Snow applauded Governor Henry for signing legislation that allows Oklahoma's high risk pool available to those eligible for the Health Coverage Tax Credit Program (HCTC). The program will help cover the cost of health insurance premiums for many Oklahoma residents.

"I would like to thank the Republicans and Democrats in the legislature who voted for this legislation and Governor Henry for signing it," stated Treasury Secretary John Snow. "I would also like to thank Insurance Commissioner Carroll Fisher, Employment Security Commissioner Jon Brock and other interested parties in Oklahoma who have worked so hard to make the Health Coverage Tax Credit program available to over 3,000 workers and their families. I commend them for their leadership in enacting legislation that makes the state's high risk pool available to those eligible for TAA benefits. The HCTC program is a real innovation in tax policy, one that we hope will lead the way for other innovations that help real people obtain the health care coverage that they need in a flexible and reliable way. We want to ensure that those who qualify for the credit get the help they need as quickly as possible."

The Trade Adjustment Assistance Act President Bush signed into law in 2002 included the new Health Coverage Tax Credit (HCTC). Recipients can receive the HCTC either in advance, to help pay qualified health plan premiums as they come due, or in a lump sum when they file their federal tax returns. The HCTC advance payments program began nationally in August 2003. This program provides an advanced payment of 65% of the premium cost for a qualified health plan for individuals who are eligible to receive Trade Adjustment Assistance (TAA) benefits or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

In order to receive the credit, eligible individuals must enroll in qualified health insurance, such as a COBRA health plan or State Qualified Health Plan (SQHP). Thirty-four states and the District of Columbia have SQHPs that will enable more than 200,000 of those potentially eligible for the HCTC to purchase health coverage. Nationwide, there are nearly 250,000 individuals potentially eligible for the HCTC.

For more information on a particular state and the health insurance programs that qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: HCTC.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 8, 2004
JS-1543

Under Secretary of the Treasury John B. Taylor Key Note Address at the Forum on Islamic Finance Harvard University

Understanding and Supporting Islamic Finance: Product Differentiation and International Standards

I thank the Islamic Finance Project for inviting me and for, once again, leading efforts to organize this excellent conference. I would also extend a warm welcome to all of you here. I know you will enjoy hearing from my esteemed colleague, Dr. Ahmad Mohamed Ali from the Islamic Development Bank. Harvard University continues its fine tradition of providing a strong platform to generate critical thinking to inform academics and policymakers on Islamic finance through its series of Islamic Finance Forums and through the Islamic Finance Project here at Harvard Law School.

I appreciate the opportunity to speak to you today on a topic that is very important to us in the Bush Administration, and, in particular, the U.S. Treasury. Islamic finance over the last several years has expanded throughout the world, not just in the Middle East, but in Asia, Europe and the United States. The global Islamic finance industry has grown significantly over the last 10 years and today assets are in the range of $200-$300 billion.

Though small compared to the whole global financial system, Islamic finance is growing and is already playing a significant role in the financial systems in the Middle East. We have seen a growth in product innovation, an increase in the number of financial institutions offering Islamic finance products, and an expansion beyond the Islamic countries to the UK, Switzerland, the United States, and elsewhere. With these developments, we need to deepen our understanding and awareness of Islamic finance, to protect its unique role to honor its traditions, and to ensure sound regulatory frameworks and suitable jurisprudence that allow for efficient financial intermediation.

The Bush Administration places significant importance on promoting strong vibrant financial sectors, including Islamic finance, as an integral component of advancing economic growth in emerging markets. This year, for example, we in the U.S. Treasury have been working with our G7 colleagues and Finance Ministers from the Middle East and North Africa to advance economic growth and financial sector development. These are key objectives for the G8 Summit which the United States is hosting in Sea Island, Georgia, in June. We have created a Partnership for Financial Excellence, which represents a hallmark bilateral initiative with the region that reinforces financial sector growth. This initiative targets technical assistance and training on key needs in regional finance ministries, central banks, and commercial banks. We are working with the Federal Reserve and other U.S. financial regulatory bodies and counterparts in the Middle East and North Africa to design a training program for regional bank supervisors on best practices for bank regulation and supervision. We will also be providing targeted technical assistance to governments in the areas of public finance, debt management, and financial institution strengthening.

We at the U.S. Treasury have recently deepened our engagement in Islamic finance in a number of ways.

- In April 2002, inspired by a terrific briefing on Islamic finance at Citibank's facility in Bahrain, I hosted the "Islamic Finance 101 Conference" in Washington, D.C., which was the first conference on Islamic finance for U.S. government officials and financial regulators to raise awareness of the global Islamic finance industry.
- In September 2003, Randy Quarles, Assistant Secretary of the Treasury of International Affairs, spoke about our involvement in Islamic finance at the First International Islamic Finance Conference in Washington, D.C.
- Also in September, Secretary Snow and I attended the Second International Islamic Finance Conference in Dubai. We had a remarkable opportunity to sit down with Islamic bankers to discuss the real issues they face.
- And today, I am pleased to announce today that the U.S. Treasury is launching an Islamic Finance Scholar-in-Residence program to generate more awareness and catalyze deeper policy discussions on Islamic finance domestically and internationally. We will be hiring as our first Scholar-in-Residence a noted Islamic finance expert. We intend for this scholar to work with us and others in Washington, D.C. on public policy issues related to the role and importance of Islamic finance. This new position will provide an opportunity to engage with key policymakers from the U.S. regulatory bodies and members of Congress, on comparing and contrasting Islamic finance and conventional banking, and promoting international standards. The first person to occupy this new position will be Dr. Mahmoud El-Gamal of Rice University. We look forward to his arrival in Washington, D.C. later this month.

In reviewing the agenda for today's conference, I was struck by some very interesting new areas for further research in Islamic finance. As this industry evolves, a range of new *Shari`a* compliant products are emerging. Some examples are the government and corporate bonds – so-called *sukuks* – which have seen an increase in issuances over the last few years, and the development of repo facilities, which allow for open market operations in Islamic finance banks and help in the development of a global Islamic money market. The Islamic Development Bank (IsDB) is also financing infrastructure-development projects using new mechanisms that rely on the depth and innovation in the *sukuk* market. Islamic finance securitization has also been growing both in the United States and abroad. Freddie Mac has been offering mortgage backed-securities as a financing option to the Muslim community in the United States.

As we all know, however, the process of replication or mimicking conventional banking instruments certainly does not mean that the replicated Islamic products are identical to their conventional counterparts. Dr. El-Gamal will be discussing this in his talk tomorrow on the "Limits of *Shari'a* Arbitrage and the Unrealized Potential of Islamic Finance". Deposit taking at fixed terms is a highly different business than taking equity participations, leasing, or profit sharing. And it is simpler and relatively more straightforward. Because of the transformation costs, complex Islamic financial products appear to be inherently less transparent and less efficient than conventional ones. This may have the undesirable effect of making Islamic finance a less attractive practice in the longer run. Dr. El-Gamal's calls for a fundamental paradigm shift in the development of Islamic finance to reduce complexity and increase competitiveness are thought-provoking and worthwhile to consider.

The replication and transformation of conventional financial products into their corresponding Islamic finance analogues have important implications for the regulation and supervision of Islamic financial institutions.

First, the various lending structures generate different risk and balance sheet exposures for Islamic banks that need to be carefully monitored and managed. For example, while only a few Islamic financial products generate different liquidity profiles from conventional products, the lack of uniformity of standards for "Islamic banking" practices across Islamic countries makes it difficult to apply the same prudential regulatory standards (e.g., capital adequacy requirements) across the board. This calls for more harmonization of Islamic banking practices, which in turn calls for harmonization of *Shari`a* standards at the national and international levels.

Second, the treatment of profits/losses will have consequences for the balance sheet structure and will require particular adjustments to meet minimal prudential requirements. For example, in *mudaraba* transactions[1], the bank bears full financial responsibility for any losses but shares relative profits with the client. Any losses stemming from uncollateralized equity financing may require higher loan loss provisioning and additional capital.

Third, disclosure requirements may need to be comprehensive and more frequent to inform investors of the investment techniques, so they can make decisions based on their risk preference. Maintaining clear transparency and ensuring adequate disclosure of financing mechanisms are important steps towards building the necessary foundation for Islamic finance. And with respect to firms in which financial institutions take stakes, greater transparency, along with strengthened corporate governance, are necessary.

As part of the international effort to design a regulatory framework for Islamic finance, regulators need to factor in the differences in these forms of finance and have at least minimal standards or benchmarks to gauge compliance and assess risks. There needs to be some level of consistency in regulatory treatment across the board, subject to the particular country's legal and regulatory regime. Malaysia and the GCC countries have been making notable progress on developing Islamic banking laws. Recognition and enforcement of these laws by the relevant national regulators would set the stage for making true progress on establishing internationally-accepted regulatory standards. Equally important is ensuring strong anti-money laundering oversight for these transactions targeted mainly at preserving the integrity of and bolstering investor confidence in Islamic finance.

Today's conference will set the stage for a lively exchange on these important issues. Looking ahead, there is much that remains to be accomplished. We welcome the work of the Islamic Financial Services Board (IFSB) in Malaysia and the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) in Bahrain that is looking at formulating standards for Islamic financial institutions, for example in corporate governance, accounting and capital adequacy. We look to see how policy makers mainstream their approach to Islamic finance in countries where this industry has grown significantly. The IMF as part of its overall financial surveillance work – particularly in the context of its Financial Sector Assessment Programs (FSAPs) and its Reports on Standards and Codes (ROSCs) -- should explore what, if any, systemic implications Islamic finance can have on the overall financial systems in the relevant countries, and it should also consider how its surveillance instruments can be better aligned with monitoring Islamic Finance. The World Bank through its financial sector work can enhance the effort to develop international regulatory frameworks and explore how Islamic finance can have a positive development impact in communities. International standard-setting bodies, such as IOSCO and BIS, have a role to play, first in understanding the basic implications of Islamic finance, and secondly to take into account implications of Islamic Finance on the implementation of existing standards. I hope that the international institutions, like the IMF, WB and the IsDB, work closely with national authorities to factor in a country's monetary policy framework and the capacity of the country's regulators who will eventually have to implement the standards developed by those bodies. These are but a few examples on the regulatory front.

In conclusion, developments in Islamic finance are of great interest to us at the U.S. Treasury and we look forward to the lively discussions on new product development and differentiation and on recent legal and regulatory issues that have emerged as the Islamic finance industry grows. As with conventional financing, Islamic financing will benefit from transparency, good governance and an internationally-accepted regulatory framework that will govern this important form of financing. I hope today's discussions will help inform these debates and contribute to the overall effort to raise awareness and promote action among key policy makers.

Thank you.

[1] Mudaraba transactions are essentially investment partnerships in which all the capital is provided by the financial institution while the business is managed by the entrepreneur/client. Profits are shared in pre-agreed ratios, and losses are borne by the bank (which is passed on to the depositors).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
JS-1544

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. to Join Junior Achievement in Ribbon-Cutting Ceremony for New Dennis and Judy Jones Free Enterprise Center in Chesterfield, Missouri

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. will deliver remarks about the federal government's efforts to promote financial education at a ribbon-cutting ceremony for the new Junior Achievement Dennis and Judy Jones Free Enterprise Center in Chesterfield, Missouri.

The Center will allow 5th and 8th grade students to see, touch and experience free enterprise in hands-on activities. Junior Achievement is an organization dedicated to educating young people about business, economics, and free enterprise and was founded in 1919.

WHO:
Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr.

WHAT:
Remarks on financial education at Junior Achievement ribbon-cutting ceremony.

WHEN:
Wednesday, May 12, 2004
10:30 a.m. to 12:30 p.m. (CDT) Media Availability

WHERE:
Dennis and Judy Jones / Free Enterprise Center
17337 N. Outer Road
Chesterfield, MO

***** Media interested in covering this event should call:**
Treasury's Office of Public Affairs at 202/622-2960 ***

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2004
JS-1545

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. to Present Certificate of Recognition to John Lewis Community Service in Davenport, Iowa

Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. will deliver remarks and present a Certificate of Recognition to the John Lewis Community Service (JLCS) for its efforts in financial education.

Founded in 1989, JLCS's Financial Literacy program focuses on homeownership, saving, budgeting, protecting assets and credit management.

WHO:
Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr.

WHAT:
Senior Treasury official will present a Certificate of Recognition to John Lewis Community Service for its efforts in financial education.

WHEN:
Thursday, May 13, 2004
1:45 p.m. (CDT) Media Availability

WHERE:
John Lewis Community Service
1016 W. 5th Street
Davenport, Iowa

Media interested in covering this event should call:
Treasury's Office of Public Affairs at 202/622-2960

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2004
JS-1546

Testimony of
Wayne A. Abernathy
Assistant Secretary for Financial Institutions
Department of the Treasury
Before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
United States House of Representatives

Chairman Bachus, Ranking Member Sanders, and Members of the Financial Institutions and Consumer Credit Subcommittee, I would like to thank you for this opportunity to testify on the regulatory burden faced by the nation's community banking institutions.

Small banks and thrifts provide households and small businesses services that are greatly valued by the communities in which they are located, particularly for the continuity of service that they present as well as for their close association with customers and the local community, what might even be called neighborliness. Their longstanding focus on individual customer relationships and in-depth knowledge of local area credit needs serve our nation's communities well. Of particular importance in achieving major goals set for us by President Bush, community banks' expertise in local area relationship lending enables them to provide financial services to various kinds of small businesses and hard-to-reach customers that might otherwise be overlooked.

Industry Consolidation and Small Banking Institutions

Undeniably, the U.S. banking industry has experienced significant consolidation in recent years. The 25 largest banking organizations accounted for 58 percent of all bank and thrift assets at the end of 2003, up from 39 percent 10 years earlier. If we chose $1 billion in assets as the dividing line today between small banks and medium and large banks, the total number of small banks and thrifts—those with assets under $1 billion—declined from 12,664 at year-end 1993 to 8,601 at year-end 2003, a decline of almost one third over the past 10 years. A substantial majority of banking acquisitions in the last decade has involved banks with under $1 billion in assets. Some have raised concerns about what these trends may mean for the future of community banking.

And there might be cause for alarm if we looked no further. Fortunately, chartering activity in recent years demonstrates the vitality and attractiveness of community banking. According to the Federal Deposit Insurance Corporation (FDIC), there were over 1,200 new community banks and thrifts established since the beginning of 1992. After accounting for mergers, acquisitions, and only 4 failures, almost 1,100 of these institutions continue to serve their communities today.

The profitability of small banks and thrifts has been relatively stable over the past decade, as measured both by return on assets and return on equity. Of some interest, however, larger banks have expanded their profitability in recent years. In 2003, small banks and thrifts achieved a return on assets averaging 1.14 percent, while those institutions exceeding $1 billion in assets averaged 1.42 percent. Similarly, return on equity was 11.12 percent for small banks, compared to 15.85

percent for those exceeding $1 billion in assets. In contrast, for 1993, the measures of return on assets for small and large institutions were virtually identical, while large institution return on equity exceeded that of small institutions only by about half the difference observed in 2003.

A large part of the reason for this difference may be a good news story: the capital position of small banks is strong. So it is a matter of math: small depository institutions have lower returns on equity than larger institutions in part because they have more equity relative to their assets; that is to say, small banks operate with larger capital cushions than do larger banks. At year-end 2003, small banks and thrifts had an average core capital ratio of almost 9.8 percent – almost twice the amount required for "well-capitalized" status and more than 2 percentage points higher than the average core capital ratio for larger institutions. Strong capital levels empower small banks to meet the particular—and often unique—credit needs of the household and small business borrowers in their communities, while at the same time preserving banking system safety and soundness.

Burden of Regulation on Small Banking Institutions

While we have great confidence in the strength and vitality of small banks and thrifts, their prosperity should not be taken for granted. They continue to face challenges from a variety of sources. A significant challenge to small banking institutions arises from the burden that regulations impose on their ability to compete effectively with larger bank and nonbank companies. Many regulatory requirements impose some degree of fixed costs, but these can weigh more heavily upon the comparatively smaller revenue base of community banks.

This is not a new observation. To try to compensate for this imbalance, many of our laws, regulations, and supervisory practices take into account differences between smaller and larger banking institutions in ways that help to mitigate potential competitive disadvantages for smaller institutions. For example:

- The size and complexity of the largest banking organizations require teams of federal examiners in residence year-round, while examiners visit smaller institutions only on a periodic basis.
- Smaller and less complex institutions generally have somewhat less detailed regulatory financial reporting requirements.
- Under current rules, banks and thrifts that have less than $250 million in assets and are not part of holding companies with banking assets exceeding $1 billion are subject to a streamlined Community Reinvestment Act (CRA) test.
- Smaller depository institutions have more liberal access to Federal Home Loan Bank advances (i.e., with respect to asset portfolio composition and eligible collateral) than do larger institutions.
- At year-end 2003, 2,019 small banks and thrifts received the benefits of Subchapter S corporation tax treatment, up from 604 institutions at year-end 1997.

Reducing Regulatory Burden

Still, we believe that more can and should be done to reduce burdensome regulations on our financial institutions, particularly community banking institutions, without compromising their prudential operations. As I mentioned, we are heartened by the fact that there continues to be an interest in new community bank charters. Ease of entry is a sign of the competitiveness of markets. We must be careful that regulation does not create a significant barrier to the entry of new banking firms and reduce competition among financial services providers.

In 1996, Congress passed the Economic Growth and Paperwork Reduction Act, requiring the banking regulatory agencies to identify statutory provisions and regulations that are outdated, unnecessary, or unduly burdensome, and seek public comment as part of this process. The agencies were then to take steps to reduce such burdens through rulemaking or recommend that Congress enact appropriate legislative changes.

This directive was reinforced by a recent call by President Bush that we should be sure that all federal, state, and local regulations are absolutely necessary. An interagency task force, under the direction of FDIC Vice Chairman John Reich, has taken on this important task. To begin, they grouped banking regulations into 12 categories. Last summer, the agencies published the first of a series of notices, seeking feedback from the public on three of the 12 regulatory groups: applications and reporting, powers and activities, and international operations. In January of this year, the second notice was published, requesting comment on consumer protection lending-related regulations. This careful and comprehensive approach to the review of regulations could prove fruitful in identifying ways to reduce compliance burdens on banks, especially on small banks, while also relieving corresponding strains on supervisory resources, without sacrificing important supervisory objectives.

Earlier this year, the banking agencies also issued a proposed rule that would make more community banks eligible for a streamlined CRA examination. Institutions with under $500 million in assets, rather than $250 million under current rules, would be eligible for the streamlined test. Furthermore, under the proposal, a bank or thrift meeting the small institution threshold size would no longer be subject to the CRA large bank retail test (which includes investment and service components) simply because it is part of a holding company having over $1 billion in banking assets. The agencies estimate that the proposal would cut in half (to about 11 percent of all banks and thrifts) the number of institutions subject to the large retail institution test.

Congress has joined this regulatory relief effort as well, moving forward several items of legislation to improve the competitive position of the community banking system. For example, the Treasury Department has consistently supported legislative proposals to repeal the prohibition on paying interest on demand deposits. The House of Representatives has several times passed legislation that included this repeal. Repeal of the prohibition on paying interest on demand deposits would eliminate a needless government price control and increase economic efficiency. Community banks with fewer means to maneuver around the current restrictions would be better able to compete with large banks and nonbank financial services providers in attracting business depositors. And repeal would benefit the nation's small businesses by allowing them to earn a positive return on their transaction balances. Larger businesses and larger banks today have been able to offset the lack of interest on checking accounts by using sweep accounts to earn interest or by including price concessions in other bank products.

Conclusion

Few observers would dispute that depository institutions of all sizes face a heavy regulatory burden, and that this burden falls disproportionately on the nation's small banks and thrifts. The costs of regulatory compliance are significant, and include not only burdens directly imposed on the industry, but higher levels of supervisory expenses that are ultimately passed on to banks, consumers, and taxpayers. When regulatory burdens are excessive and fail to add net value, they take a toll on the competitiveness of our financial system and on overall economic efficiency. The Treasury Department encourages efforts by the banking agencies to reduce regulatory burdens on banks of all sizes, an effort that is likely to benefit community banks and their customers in particular, and we stand ready to work with Congress to further these objectives.

Many have commented on the tremendous benefits we derive from our great dual banking system. When they do so, they usually refer to the dual system of state and national bank charters. But I think that we should include in that concept, as a sign of the great health and strength of our financial system, a vibrant, competitive array of banks of all sizes meeting the financial needs of our businesses and communities—which also come in all sizes, large and small. That is not only something worth preserving—it is something worth promoting.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 10, 2004
js-1547

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. and the Missouri Society of Certified Public Accountants Team Up to Teach a Financial Education Class at Gotsch Elementary, Affton School District in St. Louis, Missouri

Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. today joined the Missouri Society of Certified Public Accountants to team-teach a financial education class at Gotsch Elementary, AfftonSchool District in St. Louis, Missouri. While in St. Louis, Iannicola also presented a Certificate of Recognition to the International Institute of St. Louis for providing financial education to refugees and new immigrants.

"It is great to be back in Affton schools again," said Iannicola who served as president of the Affton Board of Education from 1999-2001. "It is even better when I can bring with me a great volunteer like Jerry Nichols who is representing the Missouri Society of Certified Public Accountants. Today we helped teach Affton 4th graders some of the basics of personal financial management," Iannicola went on to say.

The Missouri Society of Certified Public Accountants (MSCPA), a statewide association comprised of more than 8,500 CPAs, is dedicated to advancing CPAs and their profession through professional development, government advocacy and student-education initiatives. MSCPA offers a variety of in-school programs that teach students about accounting and the accounting profession all across Missouri. MSCPA also works with the American Institute of Certified Public Accountants (AICPA), including on national efforts to raise awareness about the crucial role certified public accountants play in financial education.

Deputy Assistant Secretary Iannicola also today presented a Certificate of Recognition to the International Institute of St. Louis for providing financial education to refugees and new immigrants. Through participation in the Individual Account (IDA) program, refugees have an opportunity to save money toward purchase of a first home, an automobile, a post-secondary education, or to open a small business. The International Institute's Personal Finance Workshops about Banking, Consumer Credit, Budgeting and Consumer Skills are held monthly and are given by staff and volunteers.

"The International Institute offers a great opportunity for those new to this country to learn essential skills related to banking, credit management and financing large purchases," Iannicola added. "It helps them avoid the pitfalls and realize the benefits of a sophisticated financial services marketplace."

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May 2002. The office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on, saving, credit management, home ownership and retirement planning. The office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies, and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2004
2004-5-12-11-22-4-28844

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 $81,875 million as of the end of that week, compared to $82,199 million as of the end of the prior week.

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

		April 30, 2004			May 7, 2004	
TOTAL		**82,199**			**81,875**	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	9,204	14,252	23,456	9,326	14,007	23,333
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,068	2,864	14,932	11,791	2,814	14,605
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			20,322			20,399
3. Special Drawing Rights (SDRs) [2]			12,445			12,492
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

		April 30, 2004			May 7, 2004	
	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

	April 30, 2004			May 7, 2004		
	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 IMF data for the prior month end.

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 11, 2004
js-1548

Treasury Clarifies Interaction of Health Savings Accounts With Other Employer-Provided Health Reimbursement Plans

Today Treasury and the IRS issued Revenue Ruling 2004-45 which clarifies how health Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs) interact with Health Savings Accounts (HSAs). The guidance provides a number of ways that individuals may have access to benefits from FSAs and HRAs and remain eligible to contribute to an HSA.

"Although the statute does not permit individuals to contribute to an HSA while being covered by general purpose health FSAs and HRAs, the guidance provides significant flexibility to employers in structuring health reimbursements for employees," stated Greg Jenner, Acting Assistant Secretary for Tax Policy.

In particular, the ruling states that eligible individuals (who must be covered by a high deductible health plan (HDHP)) may continue to contribute to an HSA while also covered by the following types of employer-provided plans that reimburse employee medical expenses:

- Limited purpose FSAs and HRAs that restrict reimbursements to certain permitted benefits such as vision, dental, or preventive care benefits.
- Suspended HRAs where the employee has elected to forgo health reimbursements for the coverage period.
- Post-deductible FSAs or HRAs that only provide reimbursements after the minimum annual deductible has been satisfied.
- Retirement HRAs that only provide reimbursements after an employee retires.

"We believe that the ability of employers to allow employees to temporarily suspend reimbursements from HRAs so they can contribute to an HSA without forfeiting accumulated HRA benefits provides important transitional relief for employers adopting high deductible health plans with HSAs," said Mr. Jenner.

The guidance also provides that combinations of these arrangements may also be provided without disqualifying an individual from contributing to an HSA. In addition, the ruling clarifies that individuals with coverage by an FSA and an HRA, as well as an HSA, may reimburse expenses through the FSA or HRA prior to taking distributions from the HSA, as long the individual does not seek multiple tax-favored reimbursements for the same expense.

The text of Rev. Rul. 2004-45 is attached.

-30-

REPORTS

- Rev. Rul. 2004-45

Section 223 - Health Savings Accounts—Interaction with Other Health Arrangements

Rev. Rul. 2004-45

ISSUE

In the situations described below, may an individual make contributions to a Health Savings Account (HSA) under section 223 of the Internal Revenue Code if the individual is covered by a high deductible health plan (HDHP) and also covered by a health flexible spending arrangement (health FSA) or a health reimbursement arrangement (HRA)?

FACTS

Situation 1. An individual is covered by an HDHP (as defined under section 223(c)(2)(A)). The HDHP has an 80/20 percent coinsurance feature above the deductible. The individual is also covered by a health FSA under a section 125 cafeteria plan and an HRA that meets the requirements of Notice 2002-45, 2002-2 C.B. 93. The health FSA and HRA pay or reimburse all section 213(d) medical expenses that are not covered by the HDHP (such as co-payments, coinsurance, expenses not covered due to the deductible and other medical expenses not covered by the HDHP). The health FSA and HRA coordinate the payment of benefits under the ordering rules of Notice 2002-45. The individual is not entitled to benefits under Medicare and may not be claimed as a dependent on another person's tax return.

Situation 2. Same facts as Situation 1, except that the health FSA and HRA are limited-purpose arrangements that pay or reimburse, pursuant to the written plan document, only vision and dental expenses (whether or not the minimum annual deductible of the HDHP has been satisfied). In addition, the health FSA and HRA pay or reimburse preventive care benefits as described in Notice 2004-23, 2004-15 I.R.B. 725.

Situation 3. Same facts as Situation 1, except that the individual is not covered by a health FSA. Under the employer's HRA, the individual elects, before the beginning of the HRA coverage period, to forgo the payment or reimbursement of medical expenses incurred during that coverage period. The decision to forgo the payment or reimbursement of medical expenses does not apply to permitted insurance, permitted coverage and preventive care ("excepted medical expenses"). See section 223(c)(1)(B) and Notice 2004-23. Medical expenses incurred during the suspended HRA coverage period (other than the excepted medical expenses if otherwise allowed to be paid or reimbursed by an HRA), cannot be paid or reimbursed by the HRA currently or later (i.e., after the HRA suspension ends). However, the employer decides to continue to make employer contributions to the HRA during the suspension period and thus the maximum available amount under the HRA is not affected by the suspension but is available for the payment or reimbursement ofthe excepted medical expenses incurred during the suspension period as well as medical expenses incurred in later HRA coverage periods.

Situation 4. Same facts as Situation 1, except that the health FSA and HRA are post-deductible arrangements that only pay or reimburse medical expenses (including the individual's 20 percent coinsurance responsibility for expenses above the deductible) after the minimum annual deductible of the HDHP has been satisfied.

Situation 5. Same facts as Situation 1, except that the individual is not covered by a health FSA. The employer's HRA is a retirement HRA that only reimburses those medical expenses incurred after the individual retires.

LAW AND ANALYSIS

Section 223(a) allows a deduction for contributions to an HSA for an "eligible individual" for any month during the taxable year. Section 223(c)(1)(A) provides that an "eligible individual" means, with respect to any month, any individual who is covered under an HDHP on the first day of such month and is not, while covered under an HDHP, "covered under any health plan which is not a high deductible health plan, and which provides coverage for any benefit which is covered under the high deductible health plan."

Section 223(b) provides a limit on amounts that can be contributed to an HSA. The maximum annual contribution limit for an eligible individual with self-only coverage is the amount required by section 223(b)(2)(A). The maximum annual contribution limit for an eligible individual with family coverage is the amount required by section 223(b)(2)(B).

Section 223(c)(2)(A) defines an HDHP as a health plan that satisfies certain requirements with respect to minimum annual deductibles and maximum annual out-of-pocket expenses. Generally, if substantially all of the coverage in a health plan that is intended to be an HDHP is provided through a health FSA or HRA, the health plan is not an HDHP.

In addition to coverage under an HDHP, section 223(c)(1)(B) provides that an eligible individual may have specifically enumerated coverage that is disregarded for purposes of the deductible. Coverage that may be disregarded includes "permitted insurance" and other specified coverage ("permitted coverage"). "Permitted insurance" is coverage under which substantially all of the coverage provided relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property, insurance for a specified disease or illness, and insurance that pays a fixed amount per day (or other period) of hospitalization. "Permitted coverage" (whether through insurance or otherwise) is coverage for accidents, disability, dental care, vision care or long-term care. Section 223(c)(2)(C) also provides a safe harbor for the absence of a preventive care deductible. See Notice 2004-23.

The legislative history of section 223 explains these provisions by stating that "eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan." The legislative history also explains that, "[a]n individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage." H.R. Conf. Rep. No. 391, 108th Cong., 1st Sess. 841 (2003).

Section 125(a) states that no amount will be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Section 125(d) defines a cafeteria plan as a written plan under which participants may choose among two or more benefits consisting of cash and qualified benefits.

Section 125(f) defines qualified benefits as any benefit not included in the gross income of the employee by reason of an express provision in the Code. Qualified benefits include employer-provided accident and health coverage under section 106, including health FSAs.

Notice 2002-45, 2002-2 C.B. 93, describes the tax treatment of HRAs. The notice explains that an HRA that receives tax-favored treatment is an arrangement that is paid for solely by the employer and not pursuant to a salary reduction election under section 125, reimburses the employee for medical care expenses incurred by the employee and by the employee's spouse and dependents, and provides reimbursement up to a maximum dollar amount with any unused portion of that amount at the end of the coverage period carried forward to subsequent coverage periods.

Notice 2002-45, Part IV, states that if an employer provides an HRA in conjunction with another accident or health plan and that other plan is provided pursuant to a salary reduction election under a cafeteria plan, then all the facts and circumstances are considered in determining whether the salary reduction is attributable to the HRA. An accident or health plan funded pursuant to salary reduction is not an HRA and is subject to the rules under section 125.

Under section 223, an eligible individual cannot be covered by a health plan that is not an HDHP unless that health plan provides permitted insurance, permitted coverage or preventive care. A health FSA and an HRA are health plans and constitute other coverage under section 223(c)(1)(A)(ii). Consequently, an individual who is covered by an HDHP and a health FSA or HRA that pays or reimburses section 213(d) medical expenses is generally not an eligible individual for the purpose of making contributions to an HSA. See Rev. Rul. 2004-38, 2004-15 I.R.B. 717, which holds that an individual who is covered by an HDHP that does not provide prescription drug coverage and a separate prescription drug plan or rider that provides benefits before the minimum annual deductible of the HDHP has been satisfied is not an eligible individual for HSA purposes.

However, an individual is an eligible individual for the purpose of making contributions to an HSA for periods the individual is covered under the following arrangements:

Limited-Purpose Health FSA or HRA. A limited-purpose health FSA that pays or reimburses benefits for "permitted coverage" (but not through insurance or for long-term care services) and a limited-purpose HRA that pays or reimburses benefits for "permitted insurance" (for a specific disease or illness or that provides a fixed amount per day (or other period) of hospitalization) or "permitted coverage" (but not for long-term care services). In addition, the limited-purpose health FSA or HRA may pay or reimburse preventive care benefits. The individual is an eligible individual for the purpose of making contributions to an HSA because these benefits may be provided whether or not the HDHP deductible has been satisfied.

Suspended HRA. A suspended HRA, pursuant to an election made before the beginning of the HRA coverage period, that does not pay or reimburse, at any time, any medical expense incurred during the suspension period except preventive care, permitted insurance and permitted coverage (if otherwise allowed to be paid or reimbursed by the HRA). The individual is an eligible individual for the purpose of making contributions to an HSA. When the suspension period ends, the individual is no longer an eligible individual because the individual is again entitled to receive payment or reimbursement of section 213(d) medical expenses from the HRA. An individual who does not forgo the payment or reimbursement of medical expenses incurred during an HRA coverage period, is not an eligible individual for HSA purposes during that HRA coverage period.

If an HSA is funded through salary reduction under a cafeteria plan during the suspension period, the terms of the salary reduction election must indicate that the salary reduction is used only to pay for the HSA offered in conjunction with the HRA and not to pay for the HRA itself. Thus, the mere fact that an individual participates in an HSA funded pursuant to a salary reduction election does not necessarily result in attributing the salary reduction to the HRA.

Post-Deductible Health FSA or HRA. A post-deductible health FSA or HRA that does not pay or reimburse any medical expense incurred before the minimum annual deductible under section 223(c)(2)(A)(i) is satisfied. The individual is an

For example, if an employer offers a combined post-deductible health FSA and a limited-purpose health FSA, this would not disqualify an otherwise eligible individual from contributing to an HSA.

An individual may not be reimbursed for the same medical expense by more than one plan or arrangement. However, if the individual has available an HSA, a health FSA and an HRA that pay or reimburse the same medical expense, the health FSA or the HRA may pay or reimburse the medical expense, subject to the ordering rules in Notice 2002-45, Part V, so long as the individual certifies to the employer that the expense has not been reimbursed and that the individual will not seek reimbursement under any other plan or arrangement covering that expense (including the HSA).

HOLDINGS

In Situation 1, the individual is covered by an HDHP and by a health FSA and HRA that pay or reimburse medical expenses incurred before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. The health FSA and HRA pay or reimburse medical expenses that are not limited to the exceptions for permitted insurance, permitted coverage or preventive care. As a result, the individual is not an eligible individual for the purpose of making contributions to an HSA. This result is the same if the individual is covered by a health FSA or HRA sponsored by the employer of the individual's spouse. See, Rev. Rul. 2004-38.

In Situation 2, the individual is covered by an HDHP and by a health FSA and HRA that pay or reimburse medical expenses incurred before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. However, the medical expenses paid or reimbursed by the health FSA and HRA include only vision and dental benefits (which are permitted coverage) and preventive care. All of these benefits may be covered as a separate health plan, as a separate or optional rider, or as part of the HDHP and whether or not the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. The individual is an eligible individual for the purpose of making contributions to an HSA.

In Situation 3, the individual elects to forgo the payment or reimbursement of medical expenses incurred during an HRA coverage period. The suspension of payments and reimbursements by the HRA does not apply to permitted insurance, permitted coverage and preventive care (if otherwise allowed to be paid or reimbursed by the HRA). The individual is an eligible individual for the purpose of making contributions to an HSA until the suspension period ends and the individual is again entitled to receive, from the HRA, payments or reimbursements of section 213(d) medical expenses incurred after the suspension period.

In Situation 4, the health FSA and HRA payor reimburse medical expenses (including the 20 percent coinsurance not otherwise covered by the HDHP) only after the HDHP's minimum annual deductible has been satisfied. The individual is an eligible individual for the purpose of making contributions to an HSA.

In Situation 5, the HRA is a retirement HRA that only pays or reimburses medical expenses incurred after the individual retires. The individual is an eligible individual for the purpose of making contributions to an HSA before retirement because the HRA will pay or reimburse only medical expenses incurred after retirement.

DRAFTING INFORMATION

The principal author of this notice is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Tanner on (202) 622-6080 (not a toll-free call).

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1549

Hector Morales Acting United States Executive Director to the Inter-American Development Bank
Testimony before the Senate Foreign Relations Committee
May 13, 2004

Anti-Corruption Efforts of the MDBs

Mr. Chairman, members of the Committee, I am extremely pleased to be here today to discuss efforts of the Inter-American Development Bank to address corruption and increase transparency.Although I have not been in my current position for very long, I hope I can answer the Committee's questions and shed light on how the IDB operates.

One of my primary concerns is development effectiveness; by effectiveness I mean that the development efforts of the IDB can only have their intended impact if projects and policies are implemented transparently and free of corruption from inception to completion.When the bank provides loans and technical assistance grants to the most vulnerable populations of the Western Hemisphere, guaranteeing the efficacy of those resources is critical. While multilateral development banks are accountable to all shareholders, they can be important vehicles to transmit US policy interests.

I would like to focus my remarks today on three levels of anti-corruption efforts by the IDB: within the institution, by project, and by country, and provide you with a U.S. view of the Bank's progress in each of these areas. The IDB has accelerated its progress in these areas recently, but still has much work to do.The Office of the US Executive Director has been, and will continue to be, a strong advocate for reform at the IDB.I am aware of the considerable challenges facing the IDB in the area of anti-corruption.My focus in the US Executive Director's Office will continue to be on critical areas that impact the Bank's core development mandates.Among my current priorities are: an overhaul of the IDB's corporate and country project procurement systems, creation of a separate audit committee of the Board and adoption and implementation of an internationally recognized framework of internal controls, and further work on disclosure and transparency in IDB projects and policies.

Institutional Efforts

The IDB has made significant strides with respect to institutional anti-corruption issues.Progress is being made on creating an institutional culture which promotes transparency.The new Information Disclosure policy, adopted late last year, contains a strong statement on the presumption of disclosure.As a result of strong U.S. advocacy, the policy, including release of the Minutes of Executive Board meetings, advances the IDB beyond many of the standards in other MDBs and includes several of the objectives of the transparency language in Section 581 of the FY 2004 Appropriations Legislation on which the Treasury Department worked closely with this Committee.As part of the IDB policy, an annual review of implementation will be conducted.I will use this opportunity to advocate for additional measures to enhance disclosure.

As you may know, President Iglesias has made a strong commitment to fight against corruption within the Bank and in the Bank's member countries.To strengthen his pledge to fight corruption at the IDB, the Office of Institutional Integrity was created in 2003, and is now responsible for pursuing allegations of impropriety through three different Bank committees -the Oversight Committee on Fraud and Corruption, the Conduct Review Committee and the Ethics

Committee.Allegations may be reported anonymously, via a toll-free hotline, with full whistleblower protections afforded as the result of a new policy in 2003. Semimonthly reports on the activities of the Oversight Committee on Fraud and Corruption are available on the IDB's public website.Since its inception in April 2002 through April of this year, 183 allegations have been received, averaging 7 per month. The OCFC/OII has opened 92 investigations during the past two years. Also in 2003, the Board of Executive Directors adopted for the first time its own Code of Ethics as distinct from the Code of Ethics for Bank Management.

These are important steps, but they need to be strengthened by encouraging participants in IDB projects to come forward with allegations, and for those allegations to be vigorously prosecuted.

There are two additional transparency-enhancing mechanisms at the IDB which I would like to highlight: the inspection panel and the Office of Oversight and Evaluation.

The IDB's independent inspection mechanism was established in 1994 as part of the implementation of the Eighth General Increases in Resources of the Bank.During the negotiations for the Eighth Replenishment, the Governors of the Bank expressed a desire to increase the transparency, accountability and effectiveness of the Bank's performance by the introduction of an inspection function, to be performed independently of Management, which would investigate allegations by affected parties that the Bank had failed to apply correctly its own operational policies.To date there have been five requests for inspections and information on the activities of the inspection mechanism are available on the Bank's website.

The Office of Evaluation and Oversight reports directly to the Board of Directors and is independent of Bank management.The office undertakes independent and systematic evaluations of the Bank's strategies, policies, programs, activities, delivery support functions and systems.The evaluation office provides the Board of Directors with a vehicle for obtaining independent views of the effectiveness of the Bank's operations, policies, and programs.The Auditor General performs audits, reviews, and investigations designed to help assure management of the adequacy, effectiveness and efficiency of the Bank's internal controls and resource utilization.

The US Chair has been a strong advocate for reform of the IDB's corporate and project procurement systems.We pushed for a review of both systems by external consultants and management is expected to recommend concrete reforms in the near future.The US will continue to drive the agenda on this issue with the objective of creating a best-practice, transparent and accountable project procurement system at the IDB which is fully harmonized with that of the other MDBs.

Going forward, in addition to Section 581 reforms, I see three areas of focus to improve institutional transparency efforts at the IDB: mandatory disclosure of financial information for IDB employees, creation of an audit committee of the Board, and adoption and implementation of an internationally recognized framework of internal controls.To avoid conflicts of interest at the staff level, financial disclosure is a key component.The establishment of an audit committee and the adoption of a formal internal controls framework are consistent with US policy.

IDB Financed- Projects

To address corruption in the execution of bank-financed projects, the IDB has a supervision system of reviews and evaluations during the project cycle.The IDB's independent evaluation office recently completed a study of this system and found it to be deficient. Bank-wide, not all supervision requirements are met on a consistent basis, and there is no centralized authority in the Bank responsible for monitoring compliance on all of the supervision instruments.The US Chair was supportive of the evaluation's recommendations for reform, and has urged the Management to immediately address flaws in the current system.By reducing the number of reporting requirements to key reports at the beginning, mid-term, and end of a project's implementation and at the same time strengthening the consistency and quality of reporting, we expect to see improved project supervision.I intend to hold IDB management accountable for addressing the weaknesses identified by the evaluation.

Another fundamental area where the IDB can play a role in improving governance at the project level is through reform of the project procurement system.This Chair has urged the IDB to work with the other MDBs to agree on a best-practice set of procurement and consultant guidelines, standard documents and processes.Updated project procurement and consultants policies must be available to the public and referenced in all IDB investment loan agreements with Borrowers and must mandate the use of appropriate standard documents.

With respect to the private sector, the IDB Group's new private sector development strategy will promote best practices for corporate governance and social responsibility.The US has been a strong advocate of the MDBs working exclusively with those private sector firms committed to corporate governance.We have also encouraged the IDB to promote capacity building and best-practice awareness among smaller firms so that they might improve competitiveness along with governance and safeguards.

The IDB representation in each of the borrowing member countries is a key factor in improving project performance.The IDB needs to focus additional energy and resources, if necessary, on properly staffing and training the country offices so that they are capable of providing project supervision, exercising fiduciary oversight over procurement processes, and reporting back to the Bank when participants in local projects are unsatisfied with any of the fiduciary or governance aspects of IDB projects.

Anti- Corruption Efforts at the Country Level

I would like to highlight to the Committee that the Treasury Department prepares an annual report on the anti-corruption efforts of all of the Multilateral Development Banks.The report focuses on the country impact of MDB actions to improve governance.

The IDB's institutional strategy explicitly prioritizes modernization of the state as an area of Bank action.Before projects are developed, the country strategy which defines IDB's engagement will consider anti-corruption, governance, and institutional strengthening in the strategy.Public sector reform and modernization of public administration are key components in virtually every country strategy paper the IDB adopts.

In 2003, the IDB financed 19 projects for a total of $772 million for public sector reform and modernization.These projects ranged from strengthening internal controls in Brazil's Federal Court of Accounts to promoting fiscal reform in Bolivia and Peru.In 2004, the IDB has financed several projects of note: $7.8 million for capacity building of municipal governments in Panama; $25 million in concessional finance to Honduras to improve bank supervision; and a grant of $150,000 to Paraguay to improve management between the Executive and Legislative branches.

Through the Multilateral Investment Fund, the IDB also makes extensive use of grant financing for demonstration projects to show the benefits of politically difficult commitments that benefit the private sector, such as strengthening auditing and accounting standards in the Caribbean, and developing benchmarks to combat money laundering across the region.The MIF focuses on innovative private sector projects with large demonstration effects.Recent areas of activity include: accounting and auditing standards, financial sector reform and supervision, and improving regulatory frameworks.

To encourage market forces to provide a strong positive demonstration effect, the IDB has created its Business Climate Initiative, which will draw on the work of the World Bank and other multilateral institutions.The initiative will fund a diagnostic assessment of the weaknesses in country business climates, and then propose a program to target these weaknesses.

Results from early governance and anti-corruption elements of larger loans have shown that conditions for disbursement related to anti-corruption efforts such as sub-national financial reporting and investigation of financial crimes have largely been met.We need to capitalize on these incentive mechanisms and enhance the Bank's ability to achieve improvements in anti-corruption activities.

In my view, a critical area for further reform at the country level is building the capacity of project executing agencies in the country, usually Ministries or coordinating bodies of the executive branch.Executing agencies are subject to tremendous political pressures and a governing culture which often does not lend itself to full transparency.The IDB, through its long relationship with countries, is well-placed to dig deeper into the institutional culture and improve the government's use of IDB resources for the benefit of civil society.

Conclusion

In conclusion, while the pace of institutional reforms to combat corruption has accelerated recently, I recognize that the IDB still has much work to do.Because the bank is a leader in the region, a strong signal of the importance of anti-corruption and transparency initiatives in the Bank's institutional culture will have exponential effects in the countries of the region.This is an aggressive agenda, but as the largest shareholder in the Bank, the US is working aggressively on the need for further reform.

In his address to the IDB Board of Executive Directors last July, Secretary Snow remarked on the critical need to improve the investment climate in Latin America, saying that "capital is a coward" and only goes to places where it feels adequately protected.It is our job to enhance anti-corruption and transparency activities at the IDB to create the conditions for capital to flourish and for our development assistance to be effective.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1550

Carole Brookins
United States Executive Director to the World Bank
Testimony before the Senate Foreign Relations Committee
May 13, 2004

Anti-Corruption Efforts of the MDBs

Mr. Chairman, Members of the Committee, I welcome your invitation to come and speak with the Committee today on a subject which is fundamental to economic development and poverty reduction. Improving governance, increasing transparency and combating corruption are a major focus of President Bush and our agenda at the World Bank (the Bank). As the President said when he announced the Millennium Challenge Account (MCA) on March 14, 2002: "Money that is not accompanied by legal and economic reform are often times wasted. In many poor nations, corruption runs deep...When nations refuse to enact sound policies, progress against poverty is nearly impossible."

Our Administration's view is well supported by the Bank. In fact, combating corruption and building good governance have been major ongoing priorities of the World Bank since 1996. At the most recent Annual Meeting in Dubai of the World Bank and International Monetary Fund (September 23, 2003), Bank President Wolfensohn said: "There is still too much cronyism and corruption (in the developing countries). In nearly every country, it is a matter of common knowledge where the problems are and who is responsible. Frankly, there is not enough bold and consistent action against corruption, particularly at the higher levels of influence."

During my tenure as Executive Director representing the United States on the Bank's Board, I have seen up front the real impact of the World Bank on people's lives and opportunities to emerge out of poverty that good governance supported by the World Bank can make in delivering textbooks to children in Nairobi, Kenya or building a needed rural road to a village in Malang, Indonesia. Notwithstanding the compelling nature of these personal experiences, the question before us today is: How effective is the Bank in its anti-corruption efforts, thereby ensuring that its assistance can be delivered effectively and efficiently to promote economic growth and reduce poverty?

The World Bank continues to be the leader among international development institutions in a broad range of country-based initiatives to strengthen governance, build effective local institutions and increase transparency. These three components are the infrastructure for fighting corruption—both its systemic causes and in specific cases where it appears. The Bank has built a comprehensive structure that includes international advocacy, internal controls, analytical/diagnostic tools, education and training, and country operations. Among the MDBs, the Bank provides the largest amount of finance to support good governance programs, lending over $5 billion per year for reforms to strengthen public sector institutions.

The Bank's anti-corruption infrastructure has performed effectively in many aspects and in managing many challenges. However, there is more that could be done to strengthen the system. Our Administration is directly pursuing ways to get the desired results both internally and on the ground in countries where the Bank operates. This Committee's 2003 legislation, Section 581 of the FY2004 Consolidated Appropriations Act, which the Committee (working with Treasury) crafted, is an important tool for our efforts to enhance accountability and transparency.

The Bank's mandate is to end poverty in member countries by strengthening their investment climates in support of jobs and growth, and by creating local capacity to deliver services to the poor. In many cases, the Bank's services are in great demand in countries where governance standards and institutional capacities are lacking. By the very nature of its mandate, the Bank needs to be involved in these countries to help improve their governance structures. The challenge is to establish procedures that successfully mitigate the risks posed by corruption and effectively deliver on the Bank's mandate. The U.S. is fully committed to meeting this challenge.

My office has an ambitious agenda with respect to anti-corruption and transparency efforts. It approaches this issue at three levels. At the institutional level, we focus on improving the functioning of the Bank's internal control processes for preventing and responding to corruption and fraud. At the project level, we focus on encouraging the Bank to conduct analysis and design projects and lending policies that help to reduce opportunities for corruption and ensure that Bank funds will be well spent. At the country level, my office is a driving force to increase transparency and disclosure of Bank operations and anaylsis.

Institutional Efforts

As a major provider of development expertise and funding, the Bank recognizes that it must lead by example. Therefore, the World Bank has established systems to ensure institutional integrity, accountability and the rigorous investigation and resolution of cases involving fraud and corruption.

In November 2000, the World Bank created the Department of Institutional Integrity (INT) out of two preexisting offices tasked with combating corruption. The INT has played an important role in investigating allegations of misconduct by firms, individuals, and Bank staff. INT also supports training for Bank staff to identify ways to detect and deter fraud and corruption in Bank operations. In order to be proactive, anti-fraud and corruption training is provided by INT to all new Bank operations staff as part of their introductory training. The Bank has a hotline (1-800-831-0463) where the public or staff can report incidents of corruption or other inappropriate practices. Whistleblower protection is ensured and complaints may be made annonomously or confidentially.

The Bank has instituted several reforms that attempt to eliminate conflicts of interests and any possible corrupt practices among its staff. In 2003, the Bank announced the strengthening of its financial disclosure obligations for senior staff. All of the Bank's senior managers and Board members are now required to provide an annual statement listing their financial interests and those of their immediate families.

The Bank's Internal Auditing Department (IAD) guides World Bank management in establishing and maintaining strong internal controls and risk management procedures. IAD performs audits of the internal controls of business processes to assess their integrity, and provides advice on the design, implementation, and operation of internal control systems. In 1997, a special unit within IAD was created specifically to review all allegations and guard against fraud or corruption within the World Bank Group. This group works with an Oversight Committee Against Fraud and Corruption.

The Bank has taken formal steps to review its internal controls. Beginning in 1995, the Bank adopted the internationally recognized internal control framework known as COSO (Committee on Sponsoring Organizations). More recently, as part of Bank management's annual assessment of internal controls, management and the independent auditor provide letters regarding the adequacy of internal controls over external financial reporting. The two letters are published with the financial statements in the Bank's annual report.

In the area of accountability the World Bank has two key institutions, the Operations and Evaluation Department (OED) and its equivalents at the IFC and MIGA (OEG and OEU) and the Quality Assessment Group (QAG). Established in 1973, the Operations Evaluation Department (OED) is independent of management and reports directly to the Bank's Board of Executive Directors. OED evaluates the effectiveness of the Bank's operations at the project, sector, and country level, and assesses its lasting contribution to a country's overall development. Quality Assurance Group (QAG) was created in 1996 with the express purpose of improving the quality of Bank output within the broad context of alleviating poverty and achieving development impacts. QAG's mandate is to increase management and staff accountability by conducting real-time assessments of the quality of the

Bank's portfolio under implementation as well as the quality of the initial formulation of projects and programs.

A related unit, The Quality Assurance and Compliance Unit (QACU) was established in 2001 as part of the World Bank's Environmentally and Socially Sustainable Development Vice Presidency. QACU ensures that safeguard policies are implemented consistently across the regions, and gives advice on compliance with the safeguard policies in projects. Safeguard coordinators, with dedicated funding, are appointed in each region to oversee project compliance with the policies and assure that the proper steps have been taken to avoid or mitigate negative impacts.

Project-Level Efforts

The World Bank utilizes a number of effective tools to mitigate the risk of corruption in designing projects, as well as mechanisms to address instances when it finds that corrupt practices have occurred in the course of project implementation.

First, the Bank has procurement and consultant guidelines that govern the purchase of goods, civil works and consulting services financed in whole or in part from Bank loans for investment projects. The guidelines emphasize the need for economy and efficiency in the implementation of the project, the importance of transparency in the procurement process, and state that open competition is the basis for efficient public procurement. The guidelines include anti-fraud and corruption provisions and provide for debarment or other remedies if the Bank determines that firms have engaged in corrupt or fraudulent practices. If World Bank procurement guidelines have not been followed, then the Bank could declare a misprocurement and the borrowing government will lose the relevant funding.

Related to this, the Bank has actively enforced its administrative sanctions policy. Under this policy, the Bank debars firms and individuals from participating in any further Bank, or Bank-financed, projects if they are determined to have engaged in corrupt, fraudulent, collusive, or coercive practices in competing for, or in executing, a Bank contract. More than 180 companies and individuals have been debarred from doing business with the Bank, either temporarily or permanently. In addition, the World Bank refers matters to national justice officials for prosecution in cases when its internal compliance unit uncovers evidence that laws have been broken. The Bank makes the list of the debarred firms and individuals publicly available on its website. This illustrates the strong commitment the Bank has to eliminating corruption at the project-level, as well as the financial and reputational costs to the private sector of engaging in corrupt or non-compliant activities.

In 1993, the World Bank created the Inspection Panel as an independent forum to private citizens who believe that they have been or could be directly harmed by a project financed by the World Bank. Twenty-seven formal requests have been received since Inspection Panel operations began in September 1994. Panel reports are publicly available on the Bank's website. The IFC, the Bank's private sector institution, and MIGA have a Compliance Advisor/Ombudsman whose role is three fold: (1) To advise and assist IFC/MIGA to address complaints by people directly impacted by projects in a manner that is fair, objective and constructive, (2) To oversee compliance audits of IFC/MIGA, overall environmental and social performance, and specific projects, and (3) To provide independent advice to the President and management on specific projects as well as broader environmental and social policies, guidelines, procedures and resources.

The IFC has also been crucial in developing the Equator Principles that were adopted by ten leading banks from seven countries announced on June 4, 2003. The Equator Principles are a voluntary set of guidelines for managing social and environmental issues related to the financing of development projects that are based on the policies and guidelines of the World Bank and the IFC. Together, these banks represent approximately 70% of the project loan syndication market globally. In adopting the Equator Principles, a bank undertakes to provide loans only to those projects whose sponsors can demonstrate, to the satisfaction of the bank, their ability and willingness to comply with comprehensive processes aimed at ensuring that projects are developed in a socially responsible manner and according to sound environmental management practices.

However, more work is needed to address project-level concerns. Currently, the U.S. is pushing for the Bank to adopt a more systematic approach to measuring project results. This will facilitate a proactive examination early and regularly in the project life-cycle of whether Bank projects are meeting their objectives. Such examination can be a useful tool in identifying if corruption is playing a role.

Anti- Corruption Efforts at the Country Level

As mentioned above, the World Bank provides over $5 billion per year to help countries reform and strengthen governance measures that prevent and punish corruption. Numerous examples of these programs can be found in the annual report that the U.S. Treasury provides to Congress on anti-corruption actions taken by countries as a result of MDB assistance. They include programs that promote a wide range of judicial, fiscal, procurement and regulatory reform.

The World Bank and other IFIs have intensified efforts to assist countries to improve the quality of public expenditures. The Bank has increased assessment of the content and overall efficiency of public expenditures with the help of Public Expenditure Reviews (PERs), Country Financial Accountability Assessments (CFAAs), and Country Procurement Assessment Reports (CPARs). Expenditure Tracking Assessments for Highly Indebted Poor Countries (HIPCs) have also been used to evaluate budget formulation, execution and reporting in twenty-four HIPCs over the last several years. My office is pushing hard to get the Bank to conduct PERs, CPARs, and CFAAs in all borrowing countries and follow up these assessments with technical assistance and projects that address the weaknesses identified. This is particularly necessary in countries that will be receiving adjustment lending funds or direct budget support.

Another important Bank diagnostic is the Investment Climate Assessment (ICAs), which attempts to systematically analyze conditions for private investment and enterprise development in World Bank countries. These assessments examine the factors constraining market activity, in particular, the weaknesses in a country's legal, regulatory, and institutional framework. As a result, ICAs are a useful tool in identifying those areas where country reforms could have the greatest impact in stimulating private sector activity and reducing official corruption.

The World Bank has also been a leader in the research and analysis of corruption. Particularly notable is the work of the World Bank Institute (WBI) which has developed new approaches to measuring corruption and assessing its monetary and developmental impact. The World Bank has joined with some of the very civil society groups represented on one of today's panels – Transparency International – to co-host an anti-corruption workshop highlighting the challenges in overcoming vested interests against reform. Through this and similar conferences the Bank is creating a frank dialogue about the roots of corruption in the hope of building a stronger social consensus on values and ethics in borrowing member countries.

The Bank's commitment to governance and fighting corruption is further illustrated by the way in which International Development Association (IDA) resources are allocated to the seventy-seven recipient countries, which include the world's poorest nations. Governance is a major factor in the IDA performance-based allocation system, which the Bank utilizes on an annual basis to determine the amount of resources countries are eligible to receive. Consequently, countries that improve governance and efforts to combat corruption are rewarded with additional IDA resources, while those whose governance scores decline receive fewer resources. As a result, the Bank has had many requests from countries for advice and assistance in addressing issues that would improve their governance scores.

Another key element in the battle against corruption is transparency, where the Bank has been at the forefront in terms of disclosure of documents and consultation with civil society. The Bank has frequently updated its information disclosure policy to establish and institute best practices among the MDBs. My office continues to work with the Board and Management to ensure that further transparency is achieved in the context of additional improvements to the Bank's disclosure policy, consistent with legislation from Congress in the FY04 appropriations process as well as international commitments by the G-8 at last year's summit in Evian, France.

Conclusion:

The Bank has made considerable progress in establishing the foundation required to address governance and corruption in its operations and in the countries where it works. The Bank also has the leadership of senior management at the forefront on this critical issue. We cannot afford complacency however; continued effort and vigilance are required, both institutionally and in countries receiving assistance. Among the challenges going forward will be to achieve greater coherence across international institutions on issues like debarment, procurement and consultant guidelines, fiduciary standards and transparency. Most important to building a sustainable anti-corruption culture is building ownership in borrowing countries. The goal must be to increase their demand for good governance, so that they are accountable to their own citizens, who will then be better able to benefit directly from their own country's development. Mr. Chairman, the U.S. is committed to the full scope of this effort and we will continue to exercise our leadership and influence in this vital cause.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1551

Treasury Secretary Snow Statement On House Passage To Make The Expanded 10% Bracket Permanent

Today the House of Representatives acted on a measure that is solid common sense for America's working families. I applaud their vote to prevent a tax increase on the nearly 94 million people who benefit from the lowest 10% bracket. The Senate should quickly follow suit. Preventing a tax increase is essential for taxpayers at all income levels, especially those in the lower 10% bracket. The President is committed to allowing hard-working individuals and families keep more of their own money to help pay for their children's education, invest for retirement, and spend as they see fit. This action will bring greater fairness and simplicity to the tax code.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1552

Treasury Secretary Snow Hails Passage Of Health Care Initiatives That Address Affordability And Help Uninsured

I applaud the House for their efforts to make it easier for millions of Americans to afford and save for their health care costs. They passed legislation that will allow up to $500 of unused Flexible Spending Account funds to be carried forward or contributed to a Health Savings Account. They also passed the Medical Malpractice reform bill which will help control health care costs by encouraging alternative dispute resolution, requiring clear and convincing evidence for punitive awards, and controlling punitive and non-economic damages.

We will continue our efforts to make sure that all Americans have access to health care coverage, and employers help to provide affordable health insurance to their employees. The President's plan to make health care more affordable includes Association Health Plans, which will give America's working families greater access to affordable health insurance by allowing small businesses to band together through trade groups and negotiate on behalf of their employees and their families.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1553

Treasury Names New Private Sector Coordinator For Critical Financial Infrastructure Protection

Secretary John W. Snow today designated Donald F. Donahue as the new Sector Coordinator in the national effort to protect the U.S.'s critical financial infrastructure. As Sector Coordinator, Donahue will work with Treasury to respond to President Bush's call to develop strategies to strengthen and protect our critical financial infrastructure. Donahue will play a key role in ensuring that the private sector and the government work cooperatively to enhance the resilience of our financial infrastructure.

By being named Sector Coordinator, Donahue will also chair the financial industry's Financial Services Sector Coordinating Council (FSSCC). The FSSCC works closely with the Department of the Treasury and other regulators to coordinate the private sector's preparation for events that could disrupt the normal business of the financial services sector, such as cyber attacks, natural disasters and terrorist attacks.

"Our financial critical infrastructure is the lifeblood of the American economy, and since the attacks of September 11, 2001, the Bush Administration has made working together with the private sector to protect it a top priority. As the Sector Coordinator and Chairman of the Financial Services Sector Coordinating Council, Don Donahue will provide valuable leadership as we continue to enhance our security," said Secretary Snow.

In accepting this position, Donahue stated: "I look forward to working with the Department of the Treasury and others to further strengthen the resiliency of America's financial services sector. While much has been accomplished, we still have more to do."

Donahue is currently the President of the Depository Trust Corporation and Chief Operating Officer of the DTCC, where he has served since 1986. Since the integration of the Depository Trust Company and the National Securities Clearing Corporation, Mr. Donahue has been managing director for the Customer Marketing and Development Group, responsible for developing and marketing the service lines offered by DTCC's subsidiaries. This role includes strategic planning, product development, IT applications development, and technology infrastructure support and telecommunications.

During today's meeting, the contributions of outgoing Sector Coordinator and FSSCC chairwoman, Rhonda E. MacLean, were recognized. "By leading the effort to create the Financial Services Sector Coordinating Council, Rhonda MacLean achieved sector-wide participation and coordination on vital critical infrastructure protection initiatives. The financial services sector is better prepared today because of the accomplishments of the Council under Mrs. MacLean's leadership," said Snow.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 14, 2004
js-1554

Asset Forfeiture Event Stresses Importance of International Law Enforcement Cooperation

Australia, Canada, Switzerland Receive Forfeited Assets for Assisting Investigations

The U.S. Department of the Treasury today joined with officials from the Australian, Canadian and Swiss embassies to share assets forfeited through cooperative law-enforcement actions.

U.S. law enforcement works closely with our international partners to combat crime worldwide. The U.S., pursuant to statutory authority, shares the proceeds of successful forfeiture actions with countries that made possible or substantially facilitated the forfeiture of assets.

"As we all know too well, financial crimes do not confine themselves to one country's borders. As terrorists and other criminals attempt to move and hide illicit financial assets around the world, one country's forfeiture efforts, however effective and comprehensive, may not be enough to take the profit out of transnational crime," said Treasury Deputy Secretary Sam Bodman. "International cooperation is needed, and today we recognize and thank the Canadian, Australian, and Swiss governments for their support and assistance in several important asset forfeiture cases."

Joint law enforcement efforts among the U.S. and the Governments of Australia and Canada led to the arrest of Charles Hermanowski, who used his company Americable to defraud cable television networks of funds owed to them for providing programming to Americable customers. Hermanowski ultimately siphoned over $8 million dollars into his personal bank accounts. When he fled the U.S., the Royal Canadian Mounted Police (RCMP) provided surveillance and interviewed witnesses. Most significantly, the RCMP disseminated information through the fugitive alert system, which ultimately led to Hermanowski's arrest in Australia

The Australian Federal Police (AFP) provided assistance in locating and arresting Mr. Hermanowski. Notably, the AFP assisted the U.S. in its extradition proceedings by attending various court appearances.

The efforts of the Canadians and Australians led to today's sharing of over $1.2 million with each country.

The Government of Switzerland provided assistance in two separate cases, which resulted in asset forfeiture sharing of over $500,000. Investigations into the illegal activities of Michael Norton and his company Kona Kai Farms showed he imported inexpensive Central American Coffee and sold it as expensive Kona Coffee. During the course of the investigation, two Swiss bank accounts were discovered and linked to the illegal scheme. This forfeiture occurred as a result of the Government of Switzerland permitting Norton to voluntarily repatriate to the U.S. the illegal proceeds, in lieu of commencing its own forfeiture action.

The Swiss also played an important role in the IRS criminal investigation of drug trafficker Gary Waldon, which led to the forfeiture of proceeds from Mr. Waldon's illegal activity.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 14, 2004
js-1555

Secretary Snow Visits New York on Monday to Present New Market Tax Credit Awards to Seven Local Organizations

Secretary John W. Snow will travel to New York City on Monday, May 17 to present New Market Tax Credit (NMTC) awards totaling $748 million to seven local organizations for business and economic development in low-income communities.

The presentation of the awards will take place at Federal Hall, 26 Wall Street at 10:30 am EDT. Media must arrive by 9:30 am and must wear their official media credentials.

The seven organizations selected to receive awards are: Empowerment Reinvestment Fund, LLC ($25 million), GreenPoint New Markets, L.P. ($85 million), HEDC New Markets, Inc. ($135 million), Independence Community Commercial Reinvestment Corporation ($113 million), New Jersey Community Development Entity, LLC ($125 million), Related Community Development Group, LLC ($140 million), and TCG Community Enterprises, LLC ($125 million).

The New Market Tax Credit program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most. The NMTC Program, established by Congress in December 2000, permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The credit provided to the investor totals 39 percent of the initial value of the investment and is claimed over a seven-year credit allowance period. The 62 organizations receiving tax credit allocations this year were selected through a competitive application and rigorous review process.

More information on the NMTC program can be found at www.cdfifund.gov.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2004
JS-1556

Treasury Deputy Secretary Bodman To Address The Inter-American Development Bank On Monday, May 17

Media Advisory

Deputy Secretary of the Treasury Sam Bodman will address the Inter-American Development Bank (IDB) on Monday, May 17. Secretary Bodman will make the keynote address at the IDB's Multilateral Investment Fund (MIF) Remittances Seminar.

The seminar will coincide with the MIF's release of the first state-by-state survey of remittances sent to Latin America by millions of migrants in the United States.

WHO:
Deputy Secretary of the Treasury, Samuel W. Bodman

WHAT:
Keynote Address at the IDB's Multilateral Investment Fund Remittances Seminar

WHEN:
Monday, May 17, 2004
10:15 am EDT

WHERE:
IDB Headquarters
1300 New York Avenue
9th Floor - Andres Bello Auditorium
Washington, D.C.

- 30 -

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2004
js-1557

Treasury Secretary John Snow Presents $748 Million in Economic Development Tax Credits in New York City to Help Low-Income Communities through New Market Tax Credit Program

Secretary John W. Snow today presented New Markets Tax Credits Awards totaling $748 million to seven New York area economic development organizations that promote business and economic development in low-income communities.

The presentation of the awards took place at Federal Hall in New York City.

The seven organizations receiving awards are: Empowerment Reinvestment Fund, LLC ($25 million), GreenPoint New Markets, L.P. ($85 million), HEDC New Markets, Inc. ($135 million), Independence Community Commercial Reinvestment Corporation ($113 million), New Jersey Community Development Entity, LLC ($125 million), Related Community Development Group, LLC ($140 million), and TCG Community Enterprises, LLC ($125 million).

“The spirit and resilience of the New York area has been unwavering since the attacks of September 11. The New Market Tax Credits awards we are presenting to seven New York area community development organizations are another sign of support for the rebuilding effort that continues today. These awards will bring new hope for prosperity and growth in communities in the New York area that have been particularly hard hit,” said Secretary of the Treasury, John W. Snow

The Department of the Treasury announced on May 6, that 62 organizations have been selected to receive a total of $3.5 billion in tax credit allocations through the second round of the New Markets Tax Credit (NMTC) Program.

The New Market Tax Credit Program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most. The NMTC Program, established by Congress in December 2000, permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs).

Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The credit provided to the investor totals 39 percent of the initial value of the investment and is claimed over a seven-year credit allowance period. The 62 organizations receiving tax credit allocations this year were selected through a competitive application and rigorous review process.

"From foresting businesses in the communities of north-central Maine, to a start-up manufacturing business in south-eastern Ohio, to child-care facilities and needed shopping centers in many of our inner-city low-income neighborhoods, the New Markets Tax Credit Program has already begun to improve the communities in which these investments are being made," said Secretary Snow, highlighting the work already underway by organizations that received allocations of tax credits last year.

The NMTC Program is administered by Treasury's Community Development Financial Institutions (CDFI) Fund. The CDFI Fund anticipates that applications for the third round of the NMTC Program will be available during the summer of 2004. A complete list of 2004 New Markets recipients and additional information can be found on the CDFI Fund's Web site: www.cdfifund.gov/

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 17, 2004
JS-1558

Treasury International Capital Data For March

Treasury International Capital (TIC) data for March are released today and posted on the U.S. Treasury web site (www.treas.gov/tic). The next release date, which will report on data for April, is scheduled for June 15, 2004.

Domestic Securities

Gross purchases of domestic securities by foreigners were $1,773.9 billion in March, exceeding gross sales of domestic securities by foreigners of $1,691.6 billion during the same month.

Foreign purchases of domestic securities reached $82.3 billion on a net basis in March, relative to $85.0 billion during the previous month. Private net flows reached $44.2 billion in March. Net private purchases of Treasury Bonds and Notes increased to $27.6 billion from $20.9 billion the preceding month. Net private purchases of Government Agency Bonds were $1.1 billion, down from $18.4 billion the previous month. Net private purchases of Corporate Bonds rose to $29.1 billion from $21.1 billion the previous month. Net private purchases of Equities declined to minus $13.5 billion from a positive $2.3 billion.

Official net purchases of U.S. securities were $38.1 billion in March, relative to $22.3 billion in February. Official net purchases of Treasury Bonds and Notes of $33.9 billion accounted for the bulk of official inflows in March, up from $16.1 billion the previous month.

Foreign Securities

Gross purchases of foreign securities owned by U.S. residents were $486.2 billion in March, relative to gross sales of foreign securities to U.S. residents of $489.9 billion during the same month.

Gross sales of foreign securities to U.S. residents exceeded purchases by $3.7 billion, highlighting a net U.S. acquisition of $4.0 billion in Foreign Equities and net U.S. sales of $0.3 billion in Foreign Bonds.

Net Long-Term Securities Flows

Net foreign purchases of both domestic and foreign long-term securities from U.S. residents were $78.6 billion in March compared with $83.3 billion in February. Net foreign purchases of long-term securities were $820.8 billion in the 12-months through March 2004 as compared to $583.4 billion during the twelve months through March 2003.

The full March data set, including adjustments for repayments of principal on asset-backed securities, as well as historical series, can be found on the TIC web site, www.treas.gov/tic

Foreigners' Transactions in Long-Term Securities with U.S. Residents
(Billions of dollars, not seasonally adjusted)

				12 Months Through					
		2002	2003	Mar-03	Mar-04	Dec-03	Jan-04	Feb-04	Mar-04
1	Gross Purchases of Domestic Securities	13,022.9	15,726.4	13,319.3	17,061.4	1,198.8	1,385.6	1,439.4	1,773.9
2	Gross Sales of Domestic Securities	12,475.4	14,981.4	12,745.9	16,188.2	1,118.0	1,285.3	1,354.4	1,691.6
3	**Domestic Securities Purchased, net (line 1 less line 2) /1**	**547.6**	**745.0**	**573.4**	**873.2**	**80.8**	**100.3**	**85.0**	**82.3**
4	**Private, net /2**	**508.3**	**605.6**	**517.5**	**662.1**	**64.5**	**69.4**	**62.7**	**44.2**
5	Treasury Bonds & Notes, net	112.8	163.7	114.9	213.5	18.4	20.0	20.9	27.6
6	Gov't Agency Bonds, net	166.6	137.9	178.4	141.3	12.9	23.4	18.4	1.1
7	Corporate Bonds, net	176.7	266.1	193.0	265.1	19.7	12.5	21.1	29.1
8	Equities, net	52.2	37.9	31.2	42.2	13.5	13.4	2.3	-13.5
9	**Official, net**	**39.3**	**139.4**	**55.9**	**211.2**	**16.3**	**31.0**	**22.3**	**38.1**
10	Treasury Bonds & Notes, net	7 1	109.3	19.5	177.5	11.3	26.9	16.1	33.9
11	Gov't Agency Bonds, net	28.6	24.9	32.2	28.3	4.4	4.2	5.9	2.9
12	Corporate Bonds, net	5.6	5.5	4.8	6.2	0.7	0.5	0.2	1.2
13	Equities, net	-2.0	-0.4	-0.7	-0.9	-0.1	-0.6	0.1	0.0
14	Gross Purchases of Foreign Securities	2,640.0	3,532.9	2,718.5	4,122.7	310.4	390.7	401.9	486.2
15	Gross Sales of Foreign Securities	2,613.0	3,577 4	2,708.5	4,175.2	315.5	399.3	403.6	489.9
16	**Foreign Securities Purchased, net (line 14 less line 15) /3**	**27.0**	**-44.6**	**10.0**	**-52.5**	**-5.0**	**-8.5**	**-1.7**	**-3.7**
17	Foreign Bonds Purchased,	28.5	26.6	34.8	21.8	0.1	4.7	0.7	0.3

	net								
18	Foreign Equities Purchased, net	-1.5	-71.1	-24.8	-74.3	-5.2	-13.2	-2.4	-4.0
19	**Net Long-Term Flows (line 3 plus line 16)**	**574.6**	**700.4**	**583.4**	**820.8**	**75.8**	**91.8**	**83.3**	**78.6**

/1 Net foreign purchases of U.S. securities (+)
/2 Includes International and Regional Organizations
/3 Net U.S. acquisitions of foreign securities (-)

Source: U.S. Department of the Treasury

REPORTS

- Foreigners' Transactions in Long-Term Securities with U.S. Residents (PDF)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2004
js-1559

Remarks of Deputy Secretary of the Treasury, Samuel W. Bodman To Inter-American Development Bank Conference on Remittances

Thank you, Hector for that kind introduction, and for the terrific work that you and your colleagues are doing here at the IDB.

I would also like to thank the staff of the IDB's Multilateral Investment Fund (MIF) for organizing today's conference and for inviting me to join you today.

As I hope you know, the Treasury Department has been very supportive of the MIF, not only for its work in the area of remittances, but also for its support of microfinance and providing grants for private sector development. Your work is encouraging the growth of a small business sector throughout Latin America and the Caribbean.

Reaching out to small businesses is central to the Bush Administration's economic growth agenda in the region. As in this country, we know that small businesses do and will provide the majority of the employment opportunities in Latin America. I would also argue that a growing and vibrant small business sector fosters entrepreneurship and innovation, strengthens local financial systems, and builds grass-roots support for improvements in the business climate and democratic ideals in developing nations.

In addition to its efforts to promote small business growth, the IDB continues to do important work in the area of remittances. We know that remittances are an integral part of the American immigrant experience. For generations, families have been sending money home around the world: to Ireland and Poland . . . the Philippines and India and El Salvador and Mexico.

But this phenomenon, once hidden in plain view, is now bigger than ever. Technological advances in communication and data transfer – and a surge in labor mobility – have fueled enormous growth in remittances. Since 1995, annual remittances from the United States have nearly doubled. This dramatic growth is testimony to the hard work and commitment of workers from abroad seeking better lives for themselves and their families.

The IDB, and the MIF in particular, have made remittances part of the public discussion and policy consideration. This work has enabled us to better comprehend the impact remittances have on the United States as well as Latin America and the Caribbean.

The MIF has played a critical role in strengthening the delivery of financial services, and encouraging private sector entry into the remittance market. And the MIF continues its work in the field by improving the capacity of financial institutions that deliver these services and streamlining the remittance process. The result has been an increase in monetary flows to families in Latin America and increased productivity growth in the United States and in the region.

And this contribution goes well beyond the Americas. The pioneering work of the IDB and the MIF has created a model for global work on remittances, including current efforts through the APEC (Asian Pacific Economic Cooperation) process and by the G7 countries.

I thought I might spend a few minutes discussing our efforts in this area at the G7. In recognition of the importance of remittances around the world, the G7 is committed to facilitating remittance transfers and increasing options available to recipients to help them improve their own economic livelihood. This is a top priority issue for this year's G8 Summit to be held in Sea Island, Georgia, next month.

The G7 Global Remittance Initiative is focused on identifying and examining the barriers that impede the flow of remittances to the end-recipient. These obstacles include a lack of awareness of, trust in, or access to financial institutions that offer remittance services, limited competition in the provision of remittance services, weak technological infrastructure, and excessive regulatory barriers that deter innovation and restrict entry into this market.

The goal here is two-fold: first, to increase overall awareness of the range of services that are available; and secondly, to foster more competition, which in turn will result in affordable and accessible remittance services. Much of what the G7 is planning to accomplish this year reflects research the MIF has sponsored on the remittance market, and I thank you for that important contribution.

We hope to see our cooperative work in this area continue. Just three weeks ago, Secretary Snow spoke to the Council of the Americas and reiterated U.S. support for facilitating access to remittances from workers in the United States to their families back home. To achieve this, we are committed to working with the MIF and its donor countries to achieve the Summit of the Americas goal of cutting in half the average cost of remittance transfers in the region by 2008. This goal –announced earlier this year – will generate more competition among the providers of these services . . . eliminate regulatory obstacles and other restrictive measures that increase costs . . and encourage the use of new technologies while maintaining effective financial oversight.

The MIF has been a good partner in this effort: working to improve the collection and reporting of remittance data, encouraging the reduction of transaction costs, and identifying ways to "bank the unbanked."

The MIF has correctly focused on increasing the options senders and recipients have to save and spend their own money. This year, for example, I'm told the MIF will present two projects to help remittances sent to Mexico be used to finance housing. I think that is a very innovative example of the future directions we can take with remittances.

Remittances have become a significant force in the economies of Latin America and the Caribbean. In recent years these flows have been over five times the volume of Official Development Assistance.

I know you'll being hearing more details about remittances and their impact from Mr. Bendixen, but let me highlight a few findings of the MIF study.

This survey and report that you will discuss today presents detailed analysis of remittances from the United States, and provides particular insight into the new patterns of migration into this country.

According to the survey, remittances from the U.S. to Latin America and the Caribbean total about $30 billion annually [2002 data]. While precise numbers are very difficult to obtain, based on what this survey has found, the total income of these immigrants living in the United States is estimated to be around $450 billion.

This state-by-state analysis will assist policymakers here in the U.S. and around the world. As a former Deputy Secretary of Commerce, and now serving at the Treasury Department, I can tell you that we have an interest in these analyses throughout the U.S. government. These data highlight important and significant impacts on the U.S. economy, as well as on Latin American and Caribbean economies.

All of us have an interest in learning more about this under-studied area. This report deserves to be read and discussed, and we look forward to continue working with the Bank and the MIF.

Again, I'm happy to be here. Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 16, 2004
JS-1560

John B. Taylor
Under Secretary for International Affairs
United States Treasury
Asian Development Bank Annual Meeting
Jeju Island, Korea
May 16, 2004

It is an honor for me to be here in Jeju Island for the 37th Annual Meeting of the Asian Development Bank, and I extend my deepest thanks to our Korean hosts for their gracious arrangements in this beautiful place. I would also like to welcome ADB's newest members, Luxembourg and Palau, to the meeting. I would like to congratulate donors and ADB management on a successful conclusion to the ADF-9 replenishment.

Economic Development Agenda of the United States

Since the beginning of President Bush's time in office, he has stressed four core principles in U.S. development policy. Financial assistance for the poorest countries should be increased. More assistance should be provided in the form of grants. Development assistance should be subject to rigorous measurable results. And support should be targeted to countries that pursue pro-growth policies.

Implementation at the ADB

At the international financial institutions, including the ADB, we have worked together with many other countries to implement these principles. And we are very pleased that this cooperative effort has been a success at the ADB. Over the past several years, the Bank has demonstrated a willingness and ability to change that is impressive. We are cautiously optimistic that these changes will be sustained. Let me be specific.

Increasing Financial Assistance for the Region's Poorest Countries

The United States increased its contribution to ADF-9 by 12 percent from the previous replenishment, in line with commitments we made to IDA-13 and AfDF-9. We will consider the possibility of additional support to the ADB contingent upon the achievement of critical benchmarks for reform. Our expanded support for the Asian Bank is congruent with this administration's dramatic increase in support for HIV/AIDS and expansion in bilateral U.S. assistance to the best performing poorest countries through the Millennium Challenge Account.

Increased Grant Assistance

We particularly applaud the decision of donors, with strong support from Bank management, to devote 21 percent of ADF assistance for grants in the region's poorest and most-vulnerable countries starting in 2005. The money will fund schools, health care, sanitation, and other basic human needs where demand is greatest and resources are most scarce. Afghanistan, Laos, Cambodia, Kyrgyz Republic and Nepal will receive up to 50 percent of their assistance in the form of grants. Other vulnerable countries will also receive substantial grant allocations.

The poorest countries will be eligible for 100% grants for technical assistance and prevention and treatment of HIV/AIDS. We would like to see the flexibility and country-focus of this model adopted by other financial institutions and look forward to reviewing the ADB's progress as the first grants projects are rolled out in January.

Rigorous Measurable Results

Results measurement is no longer a slogan but a growing and essential part of the way the ADB does business. By the end of the year, the Bank has committed to put in place a new human resources policy that remunerates staff for development outputs, not lending targets. The Bank has established a dedicated office to guide implementation of results measurement at the country, sector, and project level. These results indicators will measure quantifiable outputs in infrastructure, agriculture, health and education. We look forward to reviewing the first results-based Country Strategy and Programs by the end of the year.

We would now like to see the Bank's commitments translated into more concrete actions. Results are a part of some Bank-funded projects but not all. In Afghanistan, the Bank put in place a time-bound framework for the completion of a critical Kandahar to Spin Boldak road linking Afghanistan and Pakistan to economies in Central Asia. In Cambodia, the Bank provided a critical health sector project that has improved the availability and quality of health services of more than 5 million people, including 2 million of the country's most poor, and improved pre-natal care for 2.5 million women. We would like to see this type of results measurement adopted at all levels of the ADB and in all projects and programs, public or private sector. To be effective, results management must become an integral part of the culture of the institution and be communicated by ADB top-level management to those inside and outside the institution.

Encouraging Pro-Growth Policies

The ADB should support countries that pursue good policies. It has already taken steps to strengthen its performance-based allocation system by increasing the focus on good governance and strong economic growth. These indicators should be comparable to those used by other institutions, place a premium on performance, and be transparent. In support of these objectives, we believe the ADB should place greater emphasis on providing resources directed to high-impact, productivity-enhancing activities.

There is a growing consensus that a robust private sector is critical to growth and poverty reduction. Support for small enterprises is particularly important. No country has achieved sustainable growth without a robust small business sector and no country can hope to foster innovation and generate jobs without small business growth. As an example, the Bank is providing support to small- and medium-sized enterprises in Pakistan. Nearly 30,000 small businesses will benefit from access to financial services and 8,000 from the operations of the private sector-managed Business Support Fund, which will enhance the productivity and competitiveness of these businesses. We would like to see this type of assistance substantially increased across the region. In order to do so, the Bank must marshal resources internally and continue to pursue innovative mechanisms to support private sector growth including through equity investments, guarantees, and local currency financing.

Remittance flows can also benefit from novel financing services. Nearly $30 billion in remittances flowed to Asia in 2002, representing a significant flow of income to poor families. The ADB has an important role to play in catalyzing remittance flows and increasing their cost effectiveness. A pilot remittance program has already been rolled out in the Philippines and will be discussed with APEC economies in Tokyo in June. We hope the Bank will continue to resource these important initiatives and apply lessons learned to other countries in the region.

Conclusion

The ADB has made substantial progress to become a more results-oriented and transparent institution. The key now is to implement these impressive reform policies quickly and to make this an irreversible part of the Bank's institutional culture. Private sector lending should become an increasing part of ADB operations. We will monitor progress on this reform agenda with great interest and consider the possibility of additional support to the ADB based on the achievement of critical benchmarks for reform. We hope to strengthen our partnership for reform with the ADB to address the evolving needs of the region.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1561

Economic Relations Between the United States and Japan
John B. Taylor
Under Secretary of the U.S. Treasury
Remarks at the Kyoto-Stanford Center
Kyoto, Japan
May 13, 2004

Today I would like to discuss the economic component of our foreign policy engagement with Japan. I believe that there have been important changes in this engagement during the Bush Administration, and that these changes are already beginning to show tangible results.

I am very impressed with how the Kyoto-Stanford Center has created new substantive person-to-person, business-to-business engagements between the United States and Japan. The internships of Stanford engineering and computer science students at Japanese high-tech firms and the small candid seminars given by Japanese professors here at the Center are examples of these engagements.

The recent improvements in economic relations between the governments of the United States and Japan are based on similar substantive, candid engagements, from the very top political level – meetings between President Bush and Prime Minister Koizumi – to the technical expert level – such as the roundtable meeting I had yesterday at the Bank of Japan.

Let me begin with the economic situation in Japan at the start of the Bush Administration, three and a half years ago. Growth in Japan was near zero, even negative, much as it had been for the previous ten years – a period many economists had called the "lost decade" in Japan. Even worse, Japan was plagued by a corroding deflation that had persisted for more than six years. The deflation was holding back economic growth because both consumers and businesses curtailed their spending plans, anticipating even lower prices in the future. This deflation and lack of growth made it difficult for people to service their loans and, as a result, bad loans (nonperforming loans) at banks began to grow and threaten the banking system.

A Japan in economic stagnation was clearly not in the interests of the United States. Japan is an important ally. Its growth would benefit the United States and the world economy. Its growth would provide the resources to help Japan play a key role with the United States and other allies in providing security and development assistance for emerging and developing economies. So, the lagging economy in Japan was a problem that President Bush and his Administration wanted to help the Japanese solve. After ten years of stagnation, a new approach was needed.

Opportunity for the U.S. to a change its approach was presented by two developments. First, Prime Minister Koizumi was elected to the top leadership position in Japan. Second, a much less notable event, at least for those outside of financial and economic circles, was the announcement by the Bank of Japan that it would follow a new quantitative easing policy to end deflation. This announcement showed a willingness in Japan to take a fresh approach to the economic stagnation problem. (It was an announcement I was particularly pleased to hear as I had been discussing it with Bank of Japan officials even before I came into the Bush Administration.)

Presented with these opportunities, President Bush and his team developed a new approach for our economic relations with Japan. It was based on three principles.

First, the new approach was to have no "Japan bashing." President Bush provided a clear vision on this point; he wanted our relationship with Japan to be based on friendship. Good friends talk candidly, but they talk as equals. One side doesn't talk down to the other. Some in Japan and elsewhere were concerned that our relationship with Japan – especially in the economic area – was too antagonistic and too anachronistic. This had to change.

Second, the new approach was to focus more on monetary issues and less on fiscal issues. From a technical economic view, one could say it was less Keynesian, though there was nothing doctrinaire here. In our view – and the recent BOJ announcement confirmed this – the excessive government spending and deficit creation (one Keynesian stimulus package after another) were not helping the deflation situation. Instead of fiscal stimulus based on government spending, monetary stimulus based on higher growth of the money supply was needed. For monetary policy to be effective in ending the deflation and starting growth it was necessary for the nonperforming loan problem to be addressed, so this became part of our focus on monetary policy.

Third, we focused more on *long run sustainability* of economic growth rather than *short-term fixes*. The zero-growth and deflation in Japan were a multiyear problem, not a multi-month problem. A healthy Japanese economy would be one where the next ten years would reverse the last ten years.

With these three principles in hand, we began our work on implementation. When President Bush met with Prime Minister Koizumi, they talked about these economic issues – including the nonperforming loan problem in Japan. I recall the first senior official meeting in my Washington office with our counterparts from Japan in October 2001. We discussed these issues as well as what actions the U.S. was taking to raise growth, in particular President Bush's then recently enacted tax cuts. There were many other meetings in the months and years that followed, including several here in Japan with Treasury Secretaries O'Neill and Snow. In each of these meetings and in public speeches, we stressed the three principles underlying our new approach.

I am very happy to say that this new approach is working. We have tangible results. Economic growth in Japan has returned. Experts say it is more *sustainable* than they have seen in a dozen years. Deflation is receding. And all these successes have followed the needed policy changes: increased growth of the money supply and reduction of nonperforming loans. And our Ambassador to Japan says relations between the United States and Japan have never been better!

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2004
js-1600

Uday Saddam Hussein's Inner Circle Designated by Treasury U.S. Submitting Names to U.N. 1518 Committee for Member State Freeze

The U.S. Department of the Treasury today designated a group of six individuals and two associated companies that acted for or on behalf of Uday Saddam Hussein. Today's action is the third tranche of designations against the former Iraqi regime in recent weeks. The Treasury Department has now identified or designated 228 Iraqi-related entities and individuals, comprised of 191 parastatals, 27 individuals and 10 front companies.

"The U.S. will not tire in exposing the sordid underworld of the Hussein family's finances – including the agents of the regime who greased the wheels that allowed the regime's plunder," said Juan Zarate, the Treasury Department's Deputy Assistant Secretary for Terrorist Financing and Financial Crimes.

"Like father, like son. Uday, Saddam Hussein's eldest son and commander of the paramilitary Fedayeen Saddam (`Men of Sacrifice'), presided over an illicit commercial empire founded on a variety of smuggling, racketeering and embezzlement schemes that facilitated him to use his position of power and privilege to profit himself and his cronies on the backs of the Iraqi people," Zarate continued.

Information available to the U.S. government indicates that these individuals served as key financial lieutenants to Uday and were responsible for the day-to-day operation of many of his businesses. Several of these individuals also held senior positions in the Uday-controlled Iraqi Olympic Committee which, under the former Iraqi regime, allegedly acted as a front for a variety of smuggling activities in violation of United Nations (U.N.) sanctions. One of the designated individuals served as director of the two companies being designated today, both which managed many of Uday's illegal enterprises.

Today's action is taken pursuant to Executive Order 13315 which blocks property and interests in property of the former Iraqi regime that comes within the possession or control of U.S. persons. The United States is also submitting the names of these individuals and associated companies to the U.N. with the recommendation they be listed by the 1518 Committee under U.N. Security Council Resolution (UNSCR) 1483. UNSCR 1483 requires U.N. member states to identify, freeze and transfer to the Development Fund for Iraq (DFI) assets of senior officials of the former Iraqi regime and their immediate family members, including entities owned or controlled by them or by persons acting on their behalf.

The Department of the Treasury is taking these steps to help the international community identify Iraqi assets connected to the designated individuals and entities. Treasury is also encouraging other countries to undertake independent investigations to identify other Iraqi-related assets, publish similar listings and return identified funds to the DFI.

The Treasury Department took action today against:

Asil Sami Mohammad Madhi Tabrah
Asil Tabrah served as a key assistant to Uday at the Iraqi Olympic Committee and was responsible for handling many of Uday's domestic and international financial transactions.

a.k.a. Asil Tabra
DOB: June 6, 1964
Nationality: Iraqi

Adib Shaban Al-Ani
Adib Shaban served as Uday's chief of staff and worked at the Iraqi Olympic Committee.

a.k.a. Dr. Adib Sha'ban
a.k.a. Adib Shaban
DOB: 1952
Nationality: Iraqi

Dr. Sahir Berhan
Dr. Sahir Burhan was a board member on three Iraqi companies controlled by Uday and was a member of the Iraqi Olympic Committee's executive office.

a.k.a. Dr. Sahir Barhan
a.k.a. Saher Burhan Al-Deen
a.k.a. Sahir Burhan
DOB: 1967
Address: Baghdad, Iraq
Address: United Arab Emirates
Nationality: Iraqi

General Maki Mustafa Hamudat
Maki Hamudat served as a deputy to Uday on the Iraqi Olympic Committee and was the general finance officer in charge of the budget of the Fedayeen Saddam, a paramilitary organization headed by Uday.

a.k.a. Maki Hamudat
a.k.a. Mackie Hmodat
a.k.a. General Maki Al-Hamadat
a.k.a. Macki Hamoudat Mustafa
DOB: circa 1934
Address: Mosul, Iraq

Roodi Slewa
In addition to serving as Uday's partner in an Iraqi consumer goods company,
Roodi
Slewa played a key role in Uday's illicit alcohol and cigarette distribution monopolies.
In order to conduct business under the former regime, Iraqi cigarette and alcohol vendors were required to make extortion payments to Slewa, who paid Uday approximately $1.5 million USD per month from the proceeds of this racketeering scheme.

a.k.a. Rudi Slaiwah
a.k.a. Rudi Untaywan Slaywah
a.k.a. Rudi Saliwa
Nationality: Iraqi

Nabil Victor Karam
Nabil Karam played a key role in Uday's cigarette smuggling and racketeering activities in addition to serving as the director of Trading and Transport Services and Alfa Company Limited for International Trading and Marketing, two companies that managed many of Uday's illegal enterprises.

DOB: 1954
Address: c/o Trading and Transport Services
Al-Razi Medical Complex
Jabal Al-Hussein, Amman, Jordan
P.O. Box 212953
Amman 11121, Jordan

P.O. Box 910606
Amman 11191, Jordan

Address: c/o Alfa Company Limited for International Trading and Marketing
P.O. Box 910606
Amman 11191, Jordan

Nationality: Lebanese

Trading and Transport Services Company, Ltd
Address: Al-Razi Medical Complex, Jabal Al-Hussein, Amman, Jordan
Address: P.O. Box 212953, Amman 11121, Jordan
Address: P.O. Box 910606, Amman 11191, Jordan

Alfa Company Limited For International Trading and Marketing
a.k.a. Alfa Trading Company
a.k.a. Alfa Investment and International Trading Company
Address: P.O. Box 910606, Amman 11191, Jordan

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2004
2004-5-18-14-7-46-14932

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 $81,037 million as of the end of that week, compared to $81,875 million as of the end of the prior week.

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

		May 7, 2004			May 14, 2004	
TOTAL		81,875			81,037	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	9,326	14,007	23,333	9,411	13,762	23,173
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,791	2,814	14,605	11,676	2,765	14,441
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			20,399			20,081
3. Special Drawing Rights (SDRs) [2]			12,492			12,297
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

		May 7, 2004			May 14, 2004	
	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

	May 7, 2004			May 14, 2004		
	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 IMF data for the prior month end.

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2004
JS-1661

Statement by John B. Taylor, Under Secretary of the Treasury for International Affairs, in Beijing, China

This has been a very productive visit to China and I'd like to thank Ambassador Randt for the excellent assistance of Embassy Beijing and also express my appreciation for the hospitality extended to my delegation from our Chinese hosts.

We have had in depth discussions with China's economic officials, with private economists, and with members of the financial community. I was also pleased to be joined in these meetings by Ambassador Paul Speltz, who was recently named by Treasury Secretary Snow as his personal emissary to Beijing on financial and foreign exchange issues.

This visit to Beijing is actually the first leg of a trip that will take us to three countries in Asia. Later this afternoon we will travel to Tokyo to discuss the return of economic growth there, and later this week we will travel to Korea for meetings of the Asian Development Bank where I will be discussing economic issues with finance ministers from several countries in the region. When discussing China, I think it's helpful to emphasize that China is rapidly becoming a more important trading partner of the United States, a significant engine of growth in Asia, and has a greater impact on the global economy than ever before.

The global economy is performing extraordinarily well. Thanks to good monetary and fiscal policy, the U.S. economy has recovered and is now demonstrating very strong, non-inflationary growth. Asia, of course, is growing rapidly. Japan, after many years of slow growth, has returned to solid, sustainable growth. We also see signs of growth returning to Latin America, and emerging market economies like Russia and Turkey are doing well. While growth in Europe is mixed, some countries are performing very well. And Germany and France are working to put in place policies that will lead to a return to growth.

Economic growth in China is helping to drive growth throughout Asia. There is some concern that China is "overheating." In our meetings we tried to gauge the degree of their overheating, whether there are inflationary concerns, and to understand the ways in which policymakers are dealing with these issues.

We had extensive discussions on the issue of China's exchange rate regime. That China intends to move toward greater flexibility in its exchange rate regime is very welcome and will be helpful to the world economy. We had very useful discussions as to how China intends to implement this policy and the implications this will bring for China, and for the global trading system.

I expressed my view that greater flexibility in China's exchange rate would allow for smooth adjustments and prevent the kinds of "hard landings" or "boom-bust" cycles that concern traders and investors and are so costly to any country. It's important that currency flexibility is combined with the appropriate use of monetary policy instruments and continued structural reforms in financial services.

I come away from these meetings encouraged that policymakers in China are making progress on all fronts. Our level of engagement with Chinese authorities is helping to lead to progress. President Bush and Vice-President Cheney have visited China, as has Treasury Secretary Snow, Commerce Secretary Evans and U.S. Trade Representative Zoellick. Labor Secretary Chao also plans to visit soon. In addition to these high-level meetings, in-depth discussions of key financial and economic issues continue at all levels. We recently began a Technical Cooperation Program with China to discuss financial and foreign exchange issues and expect additional meetings in June.

Our continued dialogue and cooperation on economic issues at all levels is important to ensure sustained economic growth in our own economies, in the region and in the global economy.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2004
JS-1662

The Bush Administration's Reform Agenda<br>At the Bretton Woods Institutions:
A Progress Report and Next Steps

John B. Taylor
Under Secretary of Treasury for International Affairs
Testimony Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
May 19, 2004

Chairman Shelby, Senator Sarbanes, other members of the Committee, thank you very much for inviting me to discuss the Administration's reform agenda at the International Monetary Fund and the World Bank. Reform of these institutions—founded 60 years ago at the now famous Bretton Woods Conference—has been a high priority since the start of the Bush Administration.

During the first year of the Administration we presented our reform agenda for the next few years. President Bush put forth key proposals in an important speech at the World Bank in the summer of 2001 just before going to his first G8 Economic Summit. Then, in testimony before Congress, in speeches at universities, think tanks, and in the financial community,[1][1] we discussed the technical details and the economic and political rationale for the reforms. We worked together with our fellow shareholders and with the staffs of the Bretton Woods Institutions. The importance of the reforms was stressed in statements by the Secretary of the Treasury at the IMF/World Bank meetings, by the U. S. Executive Directors at the Board meetings, and by our representatives at the replenishment negotiations of the multilateral development banks. A path-breaking international agreement on reform implementation was put forth in the form of a G7 Action Plan in April 2002.

1Examples include testimony before the Joint Economic Committee, February 4, 2002, a speech at Harvard on November 29, 2001, a speech before the Bankers Association for Finance and Trade on February 7, 2002, and most recently a speech at the IMF on April 16, from which this testimony draws.

I am happy to report that an enormous amount of rapid progress on this reform agenda has been made, especially in the last year and a half. The key reforms that have been implemented are:

- collective action clauses in external sovereign bonds;
- creation of clear limits and criteria for exceptional borrowing from the IMF;
- use of grants in partial replacement of loans from the World Bank;
- introduction of a system for measuring results at the World Bank;
- a focus on core expertise at the IMF and World Bank with division of labor.

As is true of many reform movements, people have discussed and recommended such reforms for years. The work of the Senate Banking Committee has added greatly to the discussion and debate. But in the last few years we have gone well beyond discussion and debate. What is different now is that the reforms have actually been adopted. Taken as a whole and assuming they are locked-in, internalized, and expanded as described here, these reforms, in my view, represent a fundamental policy shift for the international financial institutions.

Goals, the Evolution of Markets, and the Rationale for Reform

Simply put, the goals of the international financial institutions are (1) to increase economic and financial stability and (2) to raise economic growth, thereby reducing poverty. These are good goals. There is no reason to change them. But the world economy and financial markets in which the institutions operate has changed dramatically since they were founded, and to achieve these same goals the institutions must reform. Consider some of the changes in the world's financial markets in just the past fifteen years.

One important change is that securities represent a much bigger percentage of cross-border financial flows than in earlier years when bank loans were a larger percentage. An important implication of this change is that restructuring sovereign bonds—with literally hundreds of thousands of bondholders in many different countries—is perceived to be more difficult and uncertain than when debt was in the form of bank loans by a few banks or syndicates.

A second change is the increase in the volume of private capital flows. Private debt and equity flows grew to be much larger than official lending from the international financial institutions. Cross-border transfer payments are now predominantly private with remittances alone much larger than transfers of resources from the international financial institutions and other aid agencies.

A third change is that financial markets are more interconnected than in the past, which is one of the reasons for the concerns about contagion. The cross-border capital flows seemed to be more volatile as well.

I believe that these changes in the cross-border environment led the emerging markets to become more crisis-prone. In fact, both the number and severity of financial market crises increased in the 1990s compared with the 1980s. By the late 1990s, the emerging markets were perceived by investors as so crisis-prone that net private capital flows to emerging markets as a whole fell sharply.

The initial responses to these crises by the official community in the 1990s were understandable. As in the case of Mexico, the responses had to be developed from scratch in a very short period of time, and they had to be implemented immediately. In a number of cases, and in the Mexican case in particular, some argued that there should have been no special response by the international community, or that the response was wrong. But the point I would emphasize is that these crises were providing clearer and clearer evidence that the systemic changes in the world's financial markets required systematic changes in the policy framework underlying the international financial system.

However, the responses of the international community to crises in the 1990s continued in roughly the same fashion as the response to Mexico. They tended to concentrate on short term tactics rather than strategy. They were designed around discretionary changes in the policy instruments rather than systematic changes in the policy regime. They tended to be government-focused rather than market-focused, emphasizing large loans by the official sector and later government-induced bail-ins by the private sector. Many observers became concerned that the increasing use of very large financial packages and the bail-ins were having adverse effects on expectations or incentives.

A related problem was that loans from the official sector—including from the IMF and the World Bank—to the very poor developing countries in Latin America, Africa, and Asia were building up to clearly unsustainable levels. This led to understandable calls for debt relief. Again the responses, in my view, were more tactical than strategic. They dealt with the current serious need for debt relief, but not with the expectations effects and the incentive problems that would continue to cause the international institutions to lend too much and the poor countries to borrow too much, leading to future debt sustainability problems.

In sum, something important was missing from the international financial policy framework, namely more predictability, more accountability, and more systematic behavior on the part of the official sector. More focus needed to be placed on what public sector actions were likely to be in a given circumstance, on what accountability there would be for those actions, and on what the strategy and the principles behind the actions were.

Collective Action Clauses

The very essence of these new clauses is to provide greater predictability and order to the resolution of sovereign debt. They do this by providing a new option for sovereigns to restructure their debt without having to obtain the unanimous consent of bondholders. 75 percent has become the new threshold for amending key payment terms in sovereign bonds. I emphasize that the aim is not to make restructurings more desirable, but rather to make them more predictable and less vulnerable to 'holdouts' in cases when a country has no real alternative. In the absence of such clauses, fears and uncertainties about what would happen if a country had to begin a restructuring of its debt can interfere with effective decision-making, especially in a charged political environment. Such clauses are a decentralized, market-based approach with a minimum of direction or discretion by the official sector. In this way too, the clauses reduce the uncertainty that accompanies a non-sustainable debt situation.

Importantly, the clauses also help the official sector to be more credible about the both the likelihood and likely size of its own response, and this in turn has favorable effects on market expectations, which can reduce the need for large responses by the official sector.

The Bush Administration has actively promoted these clauses. After intensive legal and economic research at the U.S. Treasury in late 2001 and early 2002, we concluded that these were the most promising and feasible way to introduce more predictability into the system. The official sector facilitated the development of proposals, but we emphasized that the market should work out the details and, ultimately, choose what language to adopt for the clauses. The clauses then became part of the April 2002 G7 Action Plan.

We are very pleased with the dramatic progress that has been made in implementing these proposals in a very short period. Mexico included clauses for the first time in its New York law-governed bonds just about a year ago. And now clauses are well on their way to becoming standard in internationally-issued sovereign bonds. A range of countries, including the early clause-issuers Mexico, Brazil, Korea, South Africa and Turkey, have demonstrated that including these clauses in their issues has had no adverse impact on pricing. Just since January, the Philippines, Panama, Colombia, Costa Rica, Indonesia and Israel have all included these clauses for the first time in their New York-issued bonds. Work continues to educate potential issuers about the benefits of these clauses, as we advance this important trend in strengthening market practices. The new clauses are now the market standard in New York.

Some argue that these clauses do not solve all the problems about the uncertainty surrounding debt restructurings, and they are right. Future crises may not be as closely associated with debt problems as past crises have been. But the clauses and the debate surrounding them last year have helped to change perceptions about emerging market debt. The debt is now being held by a more diverse class of investors as an important part of their portfolios. Moreover, I believe that because the reform was implemented so successfully it has bolstered confidence in the reform process. People see that financial reform is possible even if it is very complex and involves changes in the policies for scores of countries and thousands of lawyers, advisors, investors, and financial institutions. For example, private creditors and borrowing countries now are working on a code of conduct, which could add more predictability and order into the system.

Clarifying Limits and Criteria for Large-Scale Official Sector Lending

There are several components of this reform.

First is the presumption—based on recent practice since the resolution of the Turkish financial crises of 2000-2001 and in particular the assistance package of early 2001—that the IMF rather than the official creditor governments is responsible for providing large scale loan financing. This provides an overall budget constraint and thereby an overall limit on loan assistance, recognizing that IMF resources are limited.

Second, within the context of this overall limit there has been an endeavor by IMF shareholders and management to signal in advance of a decision not to provide additional IMF loans when it appears that the limits of sustainability may be reached in the near future. Signaling policy changes in advance—even in broad outline—can lead to smoother adjustments and provide investors with time to obtain information about fundamentals. This reduces greatly the chances of contagion, because surprise increases or decreases in official financing can lead to runs for the exits and sudden stops. Also part of the principle of limiting funding when countries continue to follow unsustainable policies is to assist countries that are following good policies but may be hit by a crisis in the nearby country that is not following good policies. This too will help to reduce contagion in the event that the near-crisis country does in fact go into financial crisis. The clearest example of this is the case of Argentina where additional IMF resources were not suddenly stopped in 2001, but rather continued with signals—including restructuring funds built into the August 2001 program—that additional funding in the face of the ongoing debt sustainability problem would not continue. In addition a financial assistance package was provided to Uruguay—which had been following good policies—to deal with the monetary crisis brought on by the bank runs of its close neighbor in 2002.

The third component of this reform adds specificity and accountability to the first two components. This is the agreement by the IMF Board in 2002 and 2003 on four specific criteria that should be met before large scale lending above certain limits can take place. The criteria are (1) balance of payments pressures on capital account, (2) high probability of debt sustainability, (3) good prospects of regaining access to private markets so that IMF financing provides a bridge, and (4) good economic policies in place. In addition the IMF Board has adopted as a standard that, in cases of exceptional access, a new *exceptional access report* be prepared by the IMF management and published. The aim of the exceptional access report is to provide accountability in the same way that monetary policy reports or inflation reports provide some accountability at central banks.

Because these criteria must be interpreted in each case, it is clear that the limits themselves are not rigid. The reality of the market and policy environment is that the IMF management and the IMF member governments should use the criteria judiciously rather than rigidly. One cannot plan for all contingencies and so the criteria are closer to policy principles or guidelines. Nevertheless, the specific criteria represent a marked change in the direction of a more systematic and predictable policy regime.

The purpose is to reduce the uncertainty and the perverse disincentives in the markets due to lack of clarity about how much funding will be provided from the IMF and under what circumstances. The clearer limits help define the policy regime under which market participants and borrowing countries can operate. As part of the policy framework defined by the clearer access limits, the general presumption is that the official sector will avoid arm-twisting the private sector to do bail-ins, because this can lead to uncertainty about future applications and encourage early runs for the exits.

With these criteria in place, the question is frequently asked about how they were applied last year in the cases of Argentina and Brazil. In both of these cases, however, the countries were already in exceptional access territory and the goal is to exit from this exceptional access over time. The Argentina program is now focused on a complex debt restructuring. And a goal of the Brazil program is to exit from the exceptional access.

Grants Rather Than Loans to Very Poor Countries

Providing more grants to heavily indebted poor countries (HIPC) is necessary to deal with their long run debt sustainability problems. Debt forgiveness through the HIPC process in a way that deals with their debts to the international financial institutions is essential for the countries with unsustainable debt situations. But if the international financial institutions return to their heavy emphasis on lending, then there are perverse incentives for these countries to get into an unsustainable situation again, which will lead to the debt relief cycle all over again.

This is more than a simple financial issue. Unsustainable sovereign debt not only requires a government to use new resources for repayment of such debt, it reduces private sector investment needed for economic growth and poverty reduction. Using grants rather than loans, therefore, avoids leading these countries down the path of heavy indebtedness.

Of course, this is a fundamental and difficult reform. Since their founding 60 years ago, the managements and shareholders of the Bretton Woods Institutions have thought of them primarily as lending institutions. Nevertheless, remarkably good progress has been made in implementing this reform. In 2002 an international agreement was reached to use up to 21 percent of the World Banks' International Development Association (IDA) window for grants. This allows substantially larger percentages in the heavily indebted IDA countries.

The grants have proved very popular in the countries that have received them thus far, but work needs to be done to further increase grant funding for the very poorest and heavily indebted countries and to integrate this more systematically into the debt relief process.

Measurable Results Systems with Accountability and Incentives

Another change in the world economy since the founding of the Bretton Woods institutions is the mainstreaming of modern management techniques into private firms and the public sector. Effectiveness at these institutions requires that they also adopt such changes, including managing for results with clear accountability and incentives. Good progress has been made at the World Bank during 2003 in establishing a measurable results system for outcomes in countries as part of the new "measurable results incentive program" established in 2002 in the last replenishment IDA - 13.

Nevertheless, there is a need to expand to more outcome indicators in the next replenishment IDA-14 and have more shareholders use such approaches. There is also a need to develop better systems for measuring outputs at the project level and include measurable outputs with timelines in loan/grant documents and in country assistance strategies for Board approval. There is also a need to develop a similar approach at the IMF.

Focus IMF and World Bank on Core Responsibilities Allowing for Division of Labor

The core responsibilities of the IMF are monetary policy, fiscal policy, financial markets, and exchange rates. Many IMF employees comparative advantage is in these highly technical areas. Focusing on these core issues makes IMF surveillance and crisis prevention more effective. In contrast, the World Bank's core responsibilities are structural policies that raise productivity growth, such as infrastructure, business climate, education, health, and governance.

As part of the focus on the core responsibilities the IMF should concentrate its programs on a small number of core issues and leave the other issues to the World Bank, thereby creating a useful division of labor. Good progress is being made here too, but many programs, especially in very poor countries, still have IMF structural conditions that should be left to the World Bank.

Strategic Review and New Directions.

I think it is clear from this brief review that progress has been substantial. But it is also clear that more work can be done to lock-in and expand the reforms. Now seems to be an opportune time to move ahead. First, the recent progress has generated a new enthusiasm and momentum for reform—a positive feeling that by working together the international community can make progress in fundamentally reforming the international institutions, a goal that has been on people's minds since their 50th anniversary. Second, we are currently in a period not preoccupied with an immediate and emerging financial crises, which gives the relevant participants time to consider longer-term reforms. And, third, there is the occasion of the 60th anniversary.

For these reasons, Secretary John Snow, as this year's Chairman of the Group of 7 Finance Ministers and Central Bank Governors, has called for strategic review with the aim of defining new directions that build on recent reforms and, if necessary, expand them. There has already been a very positive response to Secretary Snow's initiative from developed countries, emerging market countries, and developing countries. Broad consultation is under way, so it is still too early to tell what the new directions will be, but some examples of ideas that have already been well received are:

A new non-borrowing program facility at the IMF with emphasis on strong country ownership in program design.

- A new surveillance system including a reorganization that ensures that debt sustainability analysis and other vulnerability analyses relevant to IMF lending is pursued independently from IMF lending decisions, publication of all IMF country reports, explicit allowance and encouragement of country-led development and presentation of policies for IMF assessment, and explicit focus on contagion by looking at connections between countries and assisting countries with good policies that are hit by crises in other countries.

- A further increase in the amount of grants going to poor countries from the World Bank and the other multilateral development banks in conjunction with additional debt relief in order to further improve debt sustainability, economic growth, and poverty reduction.

Conclusion

The reforms I have discussed in this testimony are technical, and may seem arcane to some. But they are deeply important for world economic growth and stability—the goal of the international financial institutions.

Thanks to the very successful implementation of reforms during the past two years as well as actual improvements in economic stability and growth in the world economy, I believe there is a willingness to consider further reform and to spend the time needed to get the technical details right as Secretary Snow has urged in his G7 "strategic review and new directions" initiative.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2004
JS-1663

Statement of Juan C. Zarate
Nominee to be Assistant Secretary for Terrorist Financing
U.S. Department of the Treasury
Before the Senate Finance Committee

Chairman Grassley, Ranking Member Baucus, and distinguished Members of this Committee, it is an honor for me to be before you today. It is a privilege to have been nominated by the President for the position of Assistant Secretary of the Treasury for Terrorist Financing, and I thank him, Secretary Snow, and Deputy Secretary Bodman for their confidence in nominating me for this important position.

Mr. Chairman, the positions for which Mr. Levey and I have been nominated form an important part of our country's long-term strategy in the war on terror. This Administration has waged an unprecedented campaign against terrorism and the financing that fuels horrendous acts of violence and hatred around the world. This is not just an American problem born on September 11th From the railway bombings of Madrid and Moscow to the commercial center attacks in Istanbul and Casablanca, we have seen that terrorism does not discriminate among race, religion, or national origin.

When I came to Washington as a federal prosecutor, Mr. Chairman, I was immersed quickly into the reality of the threat that al Qaida posed to our country. One of my first assignments was to assist in the prosecution of those responsible for the American Embassy bombings in East Africa. I further confronted the unabated viciousness of al Qaida as a prosecutor in the investigation of the murders of 17 of our countrymen and women on the USS Cole.

Just days after I began work at the Treasury Department on August 27, 2001, our world and our collective mission changed forever.

Since September 11th, I have been privileged to form part of the U.S government effort, along with Mr. Levey, to attack the financial underpinnings of terrorism.

We have achieved important successes in the mission to bankrupt terrorism. It is now harder, costlier, and riskier for al Qaida and other like-minded terror groups to raise and move money around the world. We have frozen and seized terrorist assets, exposed and dismantled known channels of funding, deterred donors, arrested key facilitators, and built higher hurdles in the international financial system to prevent abuse by terrorists.

We have forged an international coalition to combat terrorist financing, and have focused the world's attention on previously unregulated, high risk sectors like charities and hawalas. In this effort, we have also enlisted the private sector worldwide - the banks, money service businesses, broker-dealers, and the charitable sector - to serve as the front-line in this battle. These efforts have tightened the financial noose around al Qaida's neck.

The drumbeat of our drive to disrupt and dismantle terrorist financing has been constant and will continue.

Mr. Chairman, I am very proud that this work has been undertaken while our other efforts to combat money laundering, financial crimes, and enforce sanctions have also intensified. I would like to share with you a few of our actions over the past several days, which serve as good examples of the steady and important work that the Treasury continues to produce:

- Yesterday, in furtherance of our efforts to expose Saddam Hussein's financial web, we announced the designation by the Office of Foreign Assets Control of an additional six individuals and two companies that served as agents and fronts for Uday Hussein. We submitted these names to the United Nations, adding to the already 220 Iraqi-related entities listed at the U.N. Since March 2003, when Secretary Snow launched our campaign to find, freeze, and repatriate the Iraqi assets stolen by the Hussein regime, we have worked with our international partners to freeze approximately $6 billion around the world and return over $2.6 billion to the Iraqi people.
- On Friday, Treasury shared, through our Asset Forfeiture Office, over $2.5 million with the governments of Australia, Canada, and Switzerland for their assistance in money laundering investigations led by the IRS and the Bureau of Immigration and Customs Enforcement.
- Last Thursday, the Treasury's Financial Crimes Enforcement Network (FinCEN), along with the Office of Comptroller of Currency, levied a fine of $25 million against Riggs Banks for failure to comply with provisions of the Bank Secrecy Act.
- Last Tuesday, as part of the President's announcement of the sanctions to be imposed against Syria, the Secretary of the Treasury designated the Commercial Bank of Syria as a "primary money laundering concern" under Section 311 of the USA PATRIOT Act. As a result, the Secretary ordered the closing of their correspondent accounts because of that bank's complicity in dealing with the Hussein regime, its weak money laundering practices, and suspicions of terrorist financing through the institution.

This is but a mere snapshot of the important work the Treasury accomplishes every day. These efforts are critical not only to preserve the integrity of our financial system, but also to promote the national security interests of our country.

The need for this type of intensive and consolidated work in the long-term is why this Administration, in concert with Congress, decided to create the new Office of Terrorism and Financial Intelligence. TFI, as it will be called, brings under one umbrella the intelligence, enforcement, diplomatic, policy, and regulatory resources of the Treasury. It will allow us to consolidate our information and analysis to best utilize Treasury authorities to advance our national security interests and protect our financial systems. TFI will allow us to sustain these and additional efforts for the long term.

This is important, Mr. Chairman, because we know that we are in the midst of a real and protracted struggle against terrorism. We will not tire in our mission to find and incapacitate those who underwrite terror. We will continue to strengthen the financial net to protect our institutions from tainted capital flows and will continue to use all of our authorities, relationships, and expertise to attack sources, conduits and proceeds of financial crime.

Finally, Mr. Chairman, I am pleased to have with me my wife, Cindy, my parents, my brother, and friends who have supported me professionally and personally. It has been both a dream and an expectation of my parents - who immigrated from Mexico and Cuba in the 1950s in search of freedom and opportunity that my siblings and I serve this country. If confirmed, I hope to continue to serve this President and Secretary Snow with an unwavering commitment and a deep passion for these issues, and to work with this Committee and other Committees of Congress to advance our national interests.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2004
JS-1664

Statement of Stuart A. Levey
Nominee to be Under Secretary for Enforcement
U.S. Department of the Treasury

Chairman Grassley, Ranking Member Baucus, and Members of the Committee, thank you for the opportunity to appear before you today. It is truly an honor to be the nominee to serve as Under Secretary for Enforcement and as the head of the new Office of Terrorism and Financial Intelligence at the Department of the Treasury. I want to thank the President and Secretary Snow for the confidence they have shown in me by selecting me for this position.

Above all, I want to thank my wife Annette, who is the best thing in my life, for the sacrifices she has made to allow me to pursue opportunities in public service. She is the perfect wife, my best friend, a fabulous mother to our two baby daughters, and, on top of all that, a dedicated public servant at the National Institutes of Health. I would also like to thank my parents for the opportunities and support they have given me throughout my life. I am happy that my mother and stepfather, Karen and Manuel Nackes, are here with me today.

I am also grateful to Attorney General Ashcroft for the opportunity he has given me to serve at the Department of Justice. I came to the Justice Department to work for Deputy Attorney General Larry Thompson, and I have continued to serve there under Jim Comey. I have handled a variety of issues in the Deputy Attorney General's office, focusing most recently on national security and counterterrorism matters, including the Department's terrorist financing portfolio. In my current role as Principal Associate Deputy Attorney General, I serve as the Justice Department's representative to the Policy Coordinating Committee on Terrorist Financing and to the NSC's Counterterrorism Security Group. In these roles, I have established close working relationships with officials within the Department of Justice as well as in the FBI, the CIA, the State Department and elsewhere that will be valuable to me in my new position if I am confirmed.

My experience at the Justice Department makes me very mindful of the enormous responsibility that will be before me if I am confirmed. I begin almost every morning by meeting with the Attorney General, the Deputy Attorney General, the FBI Director and other senior staff to go over the most important terrorist threats that we are facing that day, both within the United States and abroad. Even after so many months, it is still chilling to hear every morning about people who are scheming to kill as many innocent people as they possibly can. Chilling, but, in a sense, motivating too. I never question why I go to work in the morning. There is so much at stake.

The financial war on terror is critical to our overall mission to defeat terrorism. Terrorists need money to operate – to recruit, to train, to travel, to communicate, and, of course, to carry out attacks. Whenever we cut off their money supply, we reduce their present abilities and force them to adopt new funding methods that are more cumbersome or risky. On another level, the audit trail that money leaves is one of our best sources of intelligence to find and disrupt terrorists. There are times when watching where the money comes from and where it goes is more valuable than taking immediate public action to stop it. We must adapt our strategy in each circumstance to do whatever is best for the overall counterterrorism mission. That is one reason why a coordinated, interagency effort is vital to our success.

Within that coordinated effort, the Treasury Department has a unique leadership role to play in the financial war on terror. The Treasury Department, working with other agencies around the government, and with the support of the Congress, has made significant progress in the fight against terrorist financing since September 11. The people who have been doing that work in the Department, including Juan Zarate, are among the most dedicated and talented public servants you will find. If I am confirmed, I will be joining a fantastic team.

I think that team would agree that there is much more work that needs to be done. If I am confirmed, I hope to bring a heightened sense of urgency to the terrorist financing mission at the Treasury Department. We must re-energize our efforts because our enemies remain committed to killing innocent people and, as this Committee has noted, our work grows more difficult as terrorists move away from known funding channels and organizations. The overarching mission for the new Office of Terrorism and Financial Intelligence will be to ensure that the Treasury Department is fully exploiting all of its authorities, capabilities and all of the government's information to combat terrorist financing and financial crime. Among other things, if I am confirmed, I would strive to make better use of the tools the Congress provided in the PATRIOT Act and of Treasury's other enforcement powers. I also would build a new Office of Intelligence and Analysis that will exploit Treasury's own information and integrate the Department more fully into the intelligence community. And, I would press terrorist financing issues as a priority with other nations around the world whose cooperation we need if we are to succeed.

I am aware that there are substantial challenges before us. Still, I am optimistic because of the steadfast support that Secretary Snow and Deputy Secretary Bodman have already shown to the cause of fighting the financial war on terror. I am also heartened by the support for this mission demonstrated by the Congress and this Committee in particular. If I am confirmed, I look forward to working with you on these important issues. I am happy to answer any questions you may have.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2004
JS-1665

Hearing Testimony
The Honorable John W. Snow
Secretary of the Treasury
On the Benefits of Health Savings Accounts (HSAs)
Before the Special Committee on Aging
United States Senate
May 19, 2004

Chairman Craig, Ranking Member Breaux and distinguished members of the Committee, thank you for the opportunity to testify before you today on the benefits of Health Savings Accounts (HSAs).

On March 16th, the President joined several small business owners to discuss health care costs and what the federal government can do about them. Dan Schmidt was one of those participants. He owns Mercury Office Supply, a Minnesota office supply retailer with 13 employees. For 2004, Mercury's annual health care premiums were set to increase to $36,000. Dan says he considered dropping coverage for his employees.

Instead, he was the first to sign up for the group HSA plan provided by Prime Health Care. The plan became effective on January 1, 2004. With the HSA, Dan's new premiums were just $24,500, saving Mercury approximately $11,500 this year. Dan is using the savings to help fund his employees HSA accounts. Dan's employees now have the coverage that they need and more control over their health care spending.

Mr. Chairman, there are thousands of employers like Dan across this country who have signed up for Health Savings Accounts in the few months they have been available. HSAs were part of the Medicare bill passed by Congress and signed by President Bush on December 8th of last year.

As Dan's example demonstrates, these accounts signal a historic change in the way we look at health care. The themes you hear from Dan and other HSA participants are consistent - they talk about lower costs, increased control, and the ability to plan for the future. HSAs reduce insurance costs, enabling more employers to begin or retain health insurance benefits for their employees. They give people more control over who they see for health care services. And they encourage saving for future medical expenses, including retiree health expenses.

The advantages of HSAs are numerous:

- HSAs encourage savings for future health care needs. Earnings from HSA balances accumulate tax free. Distributions are tax free as well, as long as they are used to pay for qualified medical expenses.

- HSAs provide people the resources they need to access health care. Individuals and their employers both can contribute pre-tax dollars into the accounts. Contributions are limited to the insurance policy's annual deductible, subject to a cap of $2,600 for individuals and $5,150 for families. Individuals aged 55-64 can make additional catch-up contributions.

- HSAs are flexible. The accounts can pay for health insurance deductibles and co-payments for medical services, products, and prescriptions. They can pay for over-the-counter drugs, long-term care insurance, and health insurance premiums during any period of unemployment. They can also pay for out-of-pocket expenses under Medicare, including premiums for Part B and the new drug benefit (Part D).

- HSAs improve upon Archer Medical Savings Accounts (MSAs). HSA are available to everyone, not just the employees of small business and the self-employed, and there is no limit on the total number of policies.

- HSAs are portable. Workers who move from job to job take the account with them, just like an Individual Retirement Account. The HSA is also owned by the individual, not the employer, and goes with the individual in the event of a job change.

HSAs put individuals in charge of their health care purchasing decisions. Consumers often find traditional health insurance plans frustrating because it sometimes feels like decisions about their health are being made by other parties... not themselves. With an HSA, health care decisions are made by the individual and their health care provider nobody else. HSAs increase the ability of individuals to make decisions that are in their own best interest.

HSAs also give consumers the opportunity to budget for their health expenses over many years. HSA balances roll over from year to year, allowing consumers to build up money in their accounts when they have low health care needs, leaving them with more money to cover out-of-pocket expenditures when the need arises.

The President's budget would further expand the availability of HSAs by allowing taxpayers an above-the-line deduction for insurance premiums associated with HSAs. This proposal would give individuals the same tax advantage that employers and the self-employed enjoy today when purchasing health insurance. This would be an important step in ensuring that the advantages of HSAs are not limited only to employer-provided health insurance.

One of our greatest challenges with HSAs is getting the word out and helping people understand how they work. Among other efforts, we have a page on our website dedicated to HSAs that includes "Frequently Asked Questions." We also set up an e-mail address hsainfo@do.treas.gov - as well as a voice mailbox: 202-622-4HSA, where individuals can submit questions.

For those in the insurance and financial community, the Treasury Department is engaged in offering a series of guidance from the IRS on some of the more pressing questions. We issued our first guidance in December, just a few weeks after the enactment. At that point we asked the public to comment and help us resolve any outstanding issues.

On March 30th of this year, we issued guidance covering the definition of "preventive care" and detailing how prescription drugs fit within the definition of the high-deductible health plan that must accompany an HSA. And just last week, we issued guidance that outlined how an employer could successfully integrate an HSA program with flexible spending arrangements and health reimbursement arrangements.

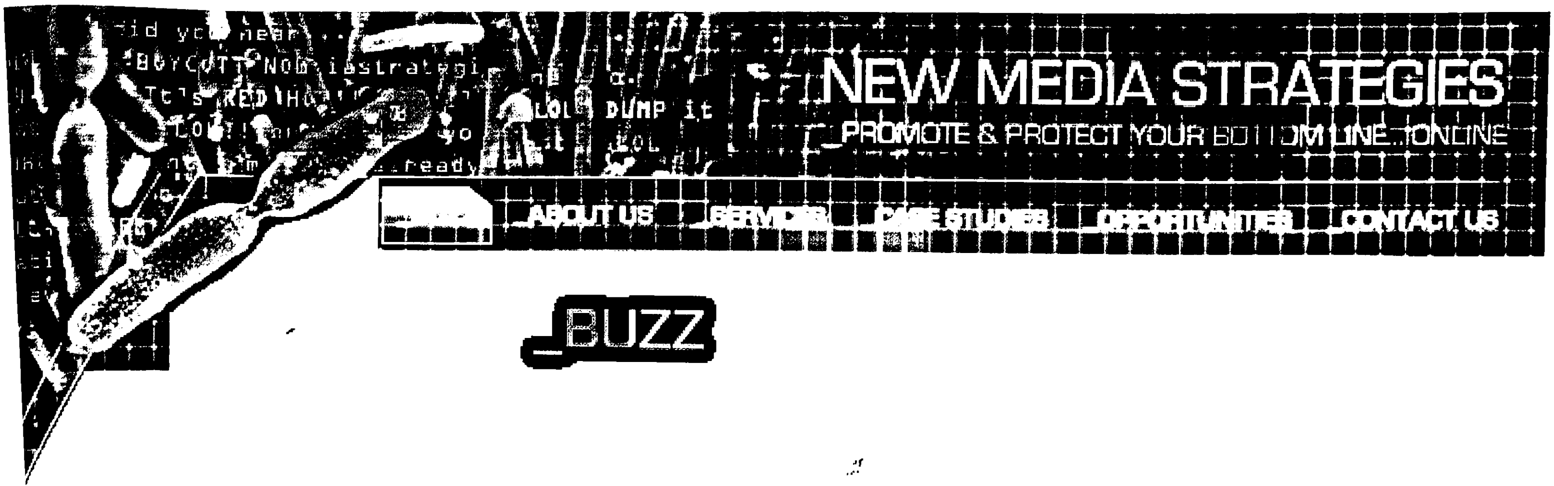
There are still issues outstanding, and we want to make sure both communities those who offer and those who use HSAs have all the guidance they need. In June, we hope to issue the next set of major guidance to further clarify how these accounts will work.

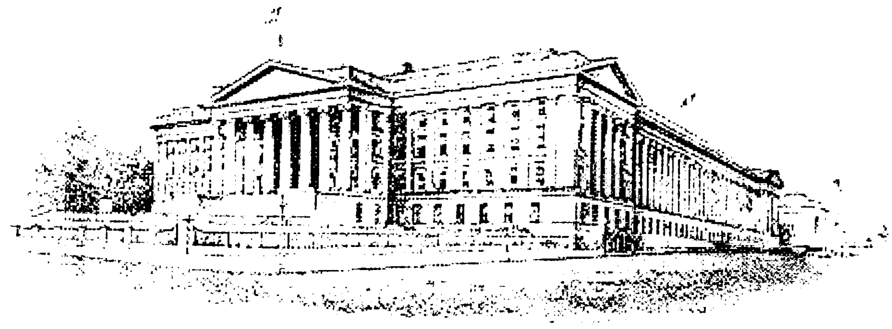
It should also be noted, Treasury is working extensively with others in the Administration to promote the availability of HSAs. The Small Business Administration, for example, has participated in the release of our previous guidance and is helping to spread the word among small business owners throughout the country by use of roundtables and other events. The Office of Personnel Management has asked health insurance carriers participating in the Federal Employees Health Benefits Program (FEHBP) to develop HSA plans for the 2005 benefit season. The Department of Labor recently issued guidance making clear that HSAs generally will not constitute an employee benefit plan under ERISA.

We will continue to work closely with those who, like we at the Treasury, are interested in making sure HSAs are available to individuals and employers across the country. For this reason, it is encouraging to see a wide variety of business and consumer interest groups - from the Hispanic Business Roundtable to the National Federation of Independent Business and the 60 Plus Association -- take a strong and active interest in HSAs.

I truly believe we will look back on the creation of Health Savings Accounts as a giant step forward in our efforts to ensure Americans have increased access to the health care services they need.

Again, thank you for the opportunity to be here today. I look forward to answering any questions you may have.





DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

For Immediate Release
May 19, 2004

Contact:
Rob Nichols (U.S.) 202-622-2920
Damian McBride (U.K.) 011-44-20-7270-5252
Leslie Slocum (U.K) 212-745-0258

Media Advisory

United States and United Kingdom to Hold Entrepreneur Summit in New York

Secretary of the Treasury John Snow and Chancellor of the Exchequer Gordon Brown will hold a conference with new and established entrepreneurs and business leaders from the United States and the United Kingdom on May 24th in New York, NY, focusing on the critical role that enterprise and innovation plays in economic progress.

Discussions at the summit will explore the lessons aspiring entrepreneurs can learn from each other in order to succeed in business, the impediments to enterprise, and how business and government can work together to address those impediments. The summit will focus on key issues such as access to capital, regulatory burdens, necessary skills, transatlantic business opportunities, research and development, and the path of innovation in the 21st Century.

"Both the U.S. and the U.K. place a high value on the contributions of entrepreneurship and small business to our economies, and our way of life," Snow said. "From entrepreneurship comes innovation and job creation; it is the foundation of any free-market system and is critical to both our national and global economies. Our hope is that this meeting will give greater impetus to entrepreneurship and enterprise on both sides of the Atlantic."

Snow also said: "The summit will provide an opportunity to compare entrepreneurial and business experiences from our two countries and to learn from each other. It should help to illustrate the connection between entrepreneurship, enterprise and economic progress as

5-1666

Not official Copy

well as a better understanding of what it takes for governments to build a successful entrepreneurial climate."

Brown said: "We will use this gathering of leaders and pioneers to strengthen the pro-Atlantic consensus and work together to break down the barriers to enterprise and growth, and build a shared commitment to wealth creation stretching across all communities and every country."

US/UK ENTREPRENEUR SUMMIT

Who:
Secretary of the Treasury John Snow and Chancellor of the Exchequer Gordon Brown. (Below is a list of entrepreneurs and business leaders participating in the summit.)

What:
Roundtable discussion with entrepreneurs and business leaders from the United States and the United Kingdom

When:
Monday, May 24, 2004
Summit begins at 10:00 am EDT
** Media should arrive no later than 9:00 am EDT, with media credentials.
** Media must RSVP no later than Friday, May 21 at 5:00 pm EDT to Pietra Jones pjones8@bloomberg.net (212-893-4476). When responding, please include information on the equipment you plan to bring.
** There will be a brief press availability following the event featuring the entrepreneurs and business leaders involved in the summit. Secretary Snow and Chancellor Brown will not participate in the press availability.

Where:
Bloomberg News Studios
499 Park Avenue at 59th Street
New York, NY

Participants in Entrepreneur Summit:

Renee Amoore, The Amoore Group
Neal Aronson, Roark Capital Group
Jeff Bleustein, Harley-Davidson, Inc.
Richard Branson, Virgin Group of Companies
Nancy Brinker, The Susan G. Komen Breast Cancer Foundation
Gordon Brown, Chancellor of the Exchequer
George Cox, The Institute of Directors
Leeanna Fournier, Providence Pediatric Medical Day Care
Barbara Franklin, Barbara Franklin Enterprises
Jerry Greenberg, Sapient
Andres Lebaudy, Fairmount Automation, Inc.
Tom Musser, The Tri-M Group, LLC
Caroline Plumb, FreshMinds Ltd.
Richard Reed, Innocent
Charlie Rose, Journalist & Event Moderator
Robin Saxby, ARM
Rick Sharp, Carmax, Inc.
John Snow, Secretary of the U.S. Treasury Department
Pete Snyder, **New Media Strategies, Inc.**
Michael Song, Visure Corp.

###

BACK TO BUZZ

New Media Strategies

© New Media Strategies, Inc., 2003

_THE INDUSTRY PIONEER & GLOBAL LEADER IN ONLINE BRAND PROMOTION & PROTECTION

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2004
JS-1667

Treasury Department Issues Information on Finance Ministers' Pre-Summit Meetings

The meeting of the Finance Ministers preceding the Group of 8 Summit will take place May 22-23, 2004 at the Waldorf-Astoria Hotel, 301 Park Avenue, New York, NY The following is a final schedule of events:

Saturday, May 22
Finance Ministers' Dinner
Mayor Michael Bloomberg's Residence
17 East 79th Street
New York, NY
7:30 pm EDT

- **Pool photo at top of event with pool reporter**

Sunday, May 23
Meetings
Waldorf-Astoria Hotel
9:00 am EDT

- **Pool coverage; national photographers as requested by country**

Group Photo
Waldorf-Astoria Hotel
12:00 pm EDT

- **Group photo is open photo with pool reporter; participating cameras should meet outside Promenade Suite A, ground level at Park Ave. entrance, at 11:00 am**

U.S. Press Conference Held by U.S. Treasury Secretary John Snow Waldorf-Astoria Hotel, Astor Salon 2:15 pm EDT

- Open to all media with appropriate media identification
- Will include release of communiqué and Secretary Snow's written statement
- All media equipment (including tape recorders) must be pre-set for security sweeps by 1:15 pm

**** There are no bilateral meetings expected at this time.**

**** The Treasury Department will not issue event-specific accreditation badges to the media. Members of the media should wear the press credentials issued to them by their media organization. Members of the media participating in press pools will be given temporary badges to wear while performing that duty.**

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2004
js-1668

Treasury Secretary Snow Statement on House Passage of the Budget Resolution

Provides Protection to Extend Expiring Tax Cuts

Today the House of Representatives acted on a measure that is both sound fiscal policy and solid common sense. Their vote provides the legislative protections needed to extend the current child tax credit of $1,000, the current marriage penalty relief, and the current 10% bracket-all of which are set to expire at the end of the year. Preventing a tax increase on millions of married couples, families with children, and those in the lower income brackets is a top priority. Returning the peoples' money to them in the form of tax cuts should not be put on equal footing with budget rules that hold Congress accountable for their spending appetites. I hope Senators recognize the importance of helping our nation's families and urge them to act quickly to make sure millions of taxpayers don't get hit with a tax hike.

The President is committed to allowing hard-working individuals and families keep more of their own money to help pay for their children's education, invest for retirement, and spend as they see fit.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
JS-1669

John B. Taylor
Under Secretary of the Treasury for International Affairs
Testimony Before the House Appropriations Subcommittee on Foreign Operations, Export Financing, and Related Programs
FY2005 Budget Request for Treasury International Programs

Chairman Kolbe, Ranking Member Lowey, Members of the Subcommittee, thank you for the opportunity to testify this morning on President Bush's FY2005 budget request for Treasury's international programs.

Treasury's international programs – which include the multilateral development banks (MDBs), debt reduction, and technical assistance – are critical instruments in promoting the Administration's international economic agenda. The MDBs promote global economic growth and poverty reduction, thereby helping to create stronger markets for U.S. goods and services. They also support specific U.S. foreign policy priorities, such as combating money laundering and terrorist financing, and rebuilding conflict-torn economies. Similarly, debt reduction can help poor countries remove debt overhang which inhibits growth and move to a sustainable level of debt. Our technical assistance helps countries institute the sound budget and financial systems needed for economic growth.

The FY2005 request for Treasury's international programs totals $1.71 billion. It includes $1.43 billion to fully fund our annual U.S. commitments to the MDBs, $58.7 million toward clearing a portion of U.S. arrears to these institutions, $200 million towards debt reduction, and $17.5 million for technical assistance.

The Economic Growth Agenda at the MDBs

The essential goal of the MDBs is to increase economic growth and thereby reduce poverty. The MDBs achieve this goal by providing financial assistance and policy advice. The productivity growth that spurs income growth depends on economic policy and governance frameworks in recipient countries.

The key elements of such policies were stated by President Bush in 2002 – to govern justly, to promote economic freedom, and to invest in people.

The MDBs also support key U.S. foreign policy priorities, such as economic reconstruction in Iraq and Afghanistan, combating money laundering and terrorist financing and fighting HIV/AIDS, especially in Africa.

Upon assuming office, the Bush Administration made it clear that the MDBs' needed to reform in order to improve their effectiveness in promoting growth and reducing poverty. Implementing such reforms were one of the highest priorities of U.S. international economic policy.

The Bush Administration has linked its financial commitment to the MDBs to the implementation of such reforms. Significant progress has been made in two key reforms: implementing a rigorous measurable results management system and providing greater grant assistance.

I am pleased to report that all the institutions are currently in the process of establishing results management systems that set measurable results with timelines at the project, sector, country, and institution level. To provide a catalyst for this effort, the U.S. introduced an incentive contribution scheme as part of our contribution to the World Bank's International Development Association (IDA) last replenishment, IDA-13, pledging an additional $300 million that is conditioned on IDA meeting specific performance and outcome targets. IDA has achieved the initial targets set for last spring, and is working to accomplish its set of outcome objectives in the areas of private sector development, health and education for this spring. An outside independent evaluation will be undertaken this spring to verify whether the targets have been met.

I am also am pleased to report that we have increased the use of grants by the MDBs to improve outcomes and avoid unsustainable debt levels in the poorest countries. Grants programs are well-established in IDA, the African Development Fund (AfDF) and the International Fund for Agricultural Development (IFAD), and the U.S. just concluded negotiating a new grant program in the Asian Development Fund (AsDF). Currently, the U.S. is seeking a significant expansion in the IDA and AfDF grant programs through the new replenishment negotiations this year. Grants have proven particularly useful in addressing the needs of those countries that have serious debt sustainability problems or are emerging from destructive conflicts, and for such critical needs as fighting the international HIV/AIDS epidemic. I recently went on a "grants" tour of Africa to assess how the new grants were working. In every country, I heard tremendous praise for the new grant programs. A particularly good grant program for education in Kenya incorporates an excellent measurable results framework.

To reinforce these reforms and strengthen the accountability of the MDBs, Treasury working closely with the Congress, has set out ambitious goals to increase the transparency of the MDBs' decision-making processes.

In particular, the United States has advocated greater availability of information on MDB projects, policies, Board meetings, fraud and corruption cases, and results indicators.

We have also asked that the MDBs make public the details of their internal systems for allocating assistance and establish a plan to conduct regular, independent audits of internal management controls.

The private sector plays a critical role in increasing growth and creating jobs in developing countries. For the last several years, the United States has urged greater emphasis on loan programs and technical assistance to small- and medium-sized enterprises (SMEs), along the lines of the IDA/International Finance Corporation (IFC) initiative to promote small business in Africa that was approved this past year. This year at the special Summit of the Americas, our Hemisphere's leaders committed to tripling the amount of bank loans available to small businesses in Latin America and the Caribbean. Because small business plays a critical role in generating jobs in most developing countries, we believe that more attention needs to be given to this critical sector by both multilateral and bilateral donors.

We are urging the MDBs to scale up their private sector development assistance, in the areas of policy advice, technical assistance and financial assistance. We have asked them to develop action plans to enact investment climate reforms. This will be a theme of the G-8 Sea Island Summit in June.

The U.S. is the largest cumulative donor to the multilateral development banks, and thus has significant influence in these institutions. Our participation in the MDBs mobilizes greater resources and generates greater impact than is available through bilateral programs alone. Our commitment to the MDBs reflects not only this resource-leveraging power, but also the enormity of the economic challenges facing developing and emerging-market countries around the world.

The FY2005 Request

There are four basic components of our FY2005 request: (1) annual funding for the MDBs, (2) arrears clearance for the MDBs, (3) debt relief, and (4) technical assistance.

(1) Annual Funding for the MDBs: $1.43 billion

The Administration's request of $1.43 billion for the MDBs includes the final regular payment of our proposed contributions to the current replenishments of IDA ($1.05 billion), the AfDF ($118 million), and the AsDF ($103 million). The request also includes the third of four payments ($107.5 million) under the current Global Environment Facility (GEF) replenishment. The $1.05 billion request for IDA includes $200 million for this year's portion of the results-based Incentive Contribution which is contingent on IDA's meeting certain performance goals. An outside independent audit, paid for by the World Bank, will review and verify the accomplishment of these goals before these additional funds are released.

(2) Arrears Clearance for the MDBs: $58.7 million

The $58.7 million request for arrears clearance is part of an effort to pay down U.S. arrears to the institutions, which totaled $472.7 million after passage of the FY2004 Appropriations Act. It is critical that the U.S. meet its international commitments, thus helping to ensure U.S. leadership and credibility on issues of vital importance to the United States.

(3) Debt Relief: $200 million

The $200 million request for debt relief includes: $75 million to complete the U.S. share of our Kananaskis Summit pledge of $150 million in additional contributions to the Heavily Indebted Poor Countries (HIPC) Trust Fund and $105 million will allow the United States to begin the process of 100 percent HIPC forgiveness on U.S. bilateral debt for the Democratic Republic of the Congo. The DRC has already qualified for HIPC treatment, and other creditors have already provided their share of debt reduction. The request also includes $20 million for debt relief under the Tropical Forest Conservation Act (TFCA) which provides debt relief to developing countries that commit to use the savings to protect their tropical forests.

Iraq's International Debt

Iraq is among the most highly indebted countries in the world with a debt to GDP ratio currently estimated at 484 percent (higher if war reparations are also included). Last September, the G-7 Finance Ministers committed to resolving this issue by the end of 2004. We have made significant progress toward this goal.

Given the importance of addressing Iraq's debt overhang, the President asked the former Secretary of the Treasury and Secretary of State, James Baker, to serve as Special Presidential Envoy to work with the world's governments at the highest levels in seeking to reduce Iraq's debt burden. Since late last year, Secretary Baker has successfully secured commitments from leaders throughout Western Europe, Asia, and the Gulf States to provide at least substantial debt reduction for Iraq in 2004. Final agreement on the amount and terms of this reduction will be negotiated between Iraq and its creditors. The Administration looks forward to working constructively with Congress to support this initiative.

(4) Technical Assistance: $17.5 million

The request also includes $17.5 million for Treasury's technical assistance programs, which form an important part of our effort to support countries facing economic developments or financial security issues, and whose governments are committed to fundamental reforms. The FY2005 request will allow us to continue current programs in the Middle East, Africa, Asia, and Central and South America, as well as allow us to expand into new countries committed to sound economic reform policies. We expect to use $8.5 million of the appropriated funds on programs that focus on anti-terrorist initiatives, to be spent in coordination with other U.S. Government agencies.

Technical Assistance in Iraq and Afghanistan

Our Office of Technical Assistance (OTA) is actively engaged in post-conflict economic restructuring activities in Afghanistan and Iraq. In both countries, the focus of the work is on the creation of sound economic frameworks upon which future growth can be built. In Afghanistan, this has involved the initiation of a streamlined government budget process, an improvement of the payment system for government salaries, and the creation of a Debt Management Unit within the Ministry of Finance which manages outstanding debts and guarantees.

In Iraq, Treasury-led effort within the Coalition Provisional Authority (CPA) has aided in the payment of Iraqi government workers and pensioners after the fall of Sadaam and the introduction of new currency. Our team also led the development of a central budget, a revitalization of its banking system, an introduction of sound management practices and transparency at the Central Bank and Ministry of Finance, the creation of a trade bank, and a strengthening of efforts aimed at combating financial crimes and terrorist financing. In addition, advice is being rendered on internal and external debt issues, including reconciling of Iraq's debt.

Authorization Requests

As part of the FY2005 budget, the Administration is seeking authorization for additional commitments to the HIPC Trust Fund in relation to President Bush's pledge at the G-7 Kananaskis Summit, for extension of authority for HIPC bilateral debt relief, and for re-authorization of the Tropical Forest Conservation Act (TFCA). I believe that it is critical that Congress pass authorization legislation for these programs, and I look forward to working with you and other Members of Congress to achieve this.

Conclusion

We will continue to work with the MDBs to make progress on implementing the strong reform agenda. I ask for your support as we strengthen these institutions in ways that increase their effectiveness in utilizing financing made possible by the taxpayers of the U.S. in serving vital U.S. economic and security interests around the world.

Our debt reduction and technical assistance programs also serve key U.S. reform and growth objectives in very important ways.

Although it is not part of the Treasury request, I cannot close without strongly urging your support for this year's Millennium Challenge Account (MCA) request, a vital component of the President's international economic agenda. As you know, the Millennium Challenge Corporation's Board, on which Secretary Snow serves, recently announced the 16 countries eligible for MCA assistance, and we are moving forward aggressively with this program. We need your support to realize the President's vision for this groundbreaking initiative.

Thank you very much. I look forward to working with you on funding this request, and I would be happy to respond to your questions.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
JS-1670

Testimony of R. Richard Newcomb, Director
Office of Foreign Assets Control
U.S. Department of the Treasury
Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

Introduction

Mr. Chairman, members of the Committee, thank you for inviting me to testify today about the Extended Custodial Inventory Program. It's a pleasure to be here again to discuss the Office of Foreign Assets Control and its relationship with the Federal Reserve Bank.

OFAC'S CORE MISSION

The primary mission of the Office of Foreign Assets Control ("OFAC") of the U.S. Department of the Treasury is to administer and enforce economic sanctions against targeted foreign countries, and groups and individuals, including terrorists and terrorist organizations and narcotic traffickers, which pose a threat to the national security, foreign policy or economy of the United States. We act under general Presidential wartime and national emergency powers, as well as specific legislation, to prohibit transactions and freeze (or "block") assets subject to U.S. jurisdiction. Economic sanctions are intended to deprive the target of the use of its assets and deny the target access to the U.S. financial system and the benefits of trade, transactions and services involving U.S. markets. These same authorities have also been used to protect assets within U.S. jurisdiction of countries subject to foreign occupation and to further important U.S. nonproliferation goals.

OFAC currently administers and enforces 28 economic sanctions programs pursuant to Presidential and Congressional mandates. These programs are a crucial element in preserving and advancing the foreign policy and national security objectives of the Untied States, and are usually taken in conjunction with diplomatic, law enforcement, and occasionally military action.

The enforcement of these programs is defined by our jurisdiction, which extends to all U.S. citizens and permanent resident aliens regardless of where they are located, all persons and entities within the United States and all U.S. incorporated entities and their foreign branches. In the case of Cuba, we also have jurisdiction with regard to foreign subsidiaries owned or controlled by U.S. companies. For the purposes of our discussion here, we will call them "U.S. persons."

OFAC has always had an outstanding relationship with the Federal Reserve, especially with the Federal Reserve Bank of New York. Because of this outstanding relationship, in early July 2003, the Federal Reserve Bank of New York contacted OFAC to indicate that it had learned that U.S. dollar banknotes held by Union Bank of Switzerland – Zurich ("UBS") may have been illegally bought from or sold to sanctioned countries by UBS in violation of its Extended Custodial Inventory ("ECI") agreement with the Federal Reserve Bank. I understand that The Federal Reserve Bank of New York had not previously been aware of the situation because officers and employees of UBS in Zurich had submitted deliberately falsified statistical reporting data.

OFAC kept in touch with the Federal Reserve Bank of New York while UBS, at the Fed's insistence, and under the oversight of Swiss banking authorities, initiated an internal investigation into the matter. UBS issued an initial report of findings, dated December 1, 2003, and a supplemental report, dated January 26, 2004. The initial report was provided to the Federal Reserve Bank with a request that it be shared with OFAC; OFAC received it electronically on January 20, 2004; the supplemental report was received electronically on January 29. OFAC immediately reviewed the material and initiated an enforcement investigation into any possible activities on the part of "U.S. persons" over whom OFAC would have jurisdiction.

The UBS/Zurich ECI contract was terminated for breach on October 28, 2003 and UBS, as you know, has paid a significant fine to the Federal Reserve Bank of New York for deception. OFAC has met with all of the key players at the Federal Reserve Bank of New York and understands that the Federal Reserve Bank, through new contracts made effective in February 2004, has taken very substantial steps to enhance controls over all remaining ECIs with respect to sanctions compliance. OFAC applauds the Federal Reserve Bank for those efforts.

I would like to thank you and the Committee for the opportunity to speak with you, Mr. Chairman, and would be happy to answer any questions.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
JS-1671

Treasury Secretary John Snow Testimony before the House Appropriations Committee Subcommittee on Transportation, Treasury and Independent Agencies

Chairman Istook, Congressman Olver, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss President Bush's FY 2005 proposed budget for the Department of the Treasury.

The President's request for FY 2005 of $11.7 billion for Treasury provides funding we need to support the core missions as identified in our new strategic plan – in promoting national prosperity through economic growth and job creation; maintaining public trust and confidence in our economic and financial systems; and ensuring the Treasury organization has the workforce, technology, and business practices to meet the nation's needs effectively and efficiently. Two key strategic objectives are to collect federal tax revenue when due through a fair and uniform application of the law and to disrupt and dismantle the financial infrastructure of terrorists, drug traffickers, and other criminals and isolate their support networks.

One historic change at Treasury in the past year has been the movement of most of the Department's law enforcement divisions – affecting some 30,000 employees – to the Department of Homeland Security and the Department of Justice. This change has provided an opportunity for Treasury to refocus on its core missions as the Federal Government's economic policymaker, financial manager, and revenue collector. This puts us in a better position to fulfill our critical role in fighting the war on terrorist financing. In addition, the Department revised and completed a new strategic plan in September 2003. To complement this strategic planning initiative, the Department and many of the bureaus underwent a restructuring of their budget activities and programs – discontinuing enforcement programs which no longer fit into the Treasury strategic vision and developing new performance goals and measures focused on getting value for taxpayers. As a result of these efforts, our FY 2005 request reflects significant reengineering and reprogramming to ensure efficient and effective use of our resources.

Mr. Chairman, we provided the Committee with a detailed breakdown and justification for President's FY 2005 budget request for Treasury. I would like to take the opportunity today to point out some highlights of our request and then I'd be happy to take whatever questions you may have.

Promoting Prosperous and Stable U.S. and World Economies

The aim of these strategic goals is to ensure that the United States and world economies perform at full economic potential. In order to perform at its full potential, the U.S. economy must increase its rate of growth and create new, high quality jobs for all Americans. Additionally, the legal and regulatory framework must support this growth by providing an environment where businesses and individuals can grow and prosper without being limited by unnecessary or obsolete rules and regulations. The Treasury Department and three of its bureaus, the Community Development Financial Institutions Fund, the Office of the Comptroller of Currency and the Office of Thrift Supervision play diverse roles in the domestic economy. From serving as the President's principal economic advisor to issuing tax refunds to millions of Americans, the Treasury has a significant influence on creating the conditions for economic prosperity in the U.S. A prosperous world economy serves the United States in many ways. It creates markets for U.S. goods and services, and it promotes stability and cooperation among nations. For these reasons, the

Department of the Treasury will work with other federal agencies and offices to promote international economic growth and raise international standards of living through interaction with foreign governments and international financial institutions. Our budget requests $158.9 million to support these strategic goals.

Maintaining Public Trust and Confidence in our Economic and Financial Systems

Treasury's mission of managing the U.S. Government's finances effectively is the bulk of the President's FY 2005 request for the Department. The budget request of $11 billion – the majority of which is for the Internal Revenue Service -- will provide funds to ensure that the tax system is fair for all while maintaining high quality service to our taxpayers and ensuring compliance with the tax laws.

In past years, IRS's focus has been on improving customer service. We believe that we have been successful in that effort and are committed to further enhancing customer service for the vast majority of American taxpayers who do their best to pay their fair share. For those who do not, fundamental fairness requires that our enforcement efforts in FY 2005 continue moving us towards a tax system in which everyone is complying with the tax laws. Our FY 2005 request, which includes a net increase of $300 million, will focus our resources toward enforcement initiatives designed to curb abusive tax practices, end the proliferation of abusive tax shelters, improve methods of identifying tax fraud, identify and stop promoters of illegal tax schemes and scams, and increase the number and effectiveness of audits to ensure compliance with the tax laws. This request will allow the IRS to apply resources to areas where non-compliance proliferates: promotions of tax schemes, misuse of offshore accounts and trusts to hide income, abusive tax shelters, underreporting of income, and failure to file and pay large amounts of employment taxes.

The President's request also provides $285 million to continue our effort in modernizing the nation's tax system through investments in technology. During the fall of 2003, the IRS performed comprehensive studies to review its modernization efforts. From these studies, the IRS has resized its modernization efforts to allow greater management focus and capacity on the most critical projects and initiatives. The IRS is also responding to these studies by increasing the business unit ownership of the projects and revising its relationships with the contractor and ensuring joint accountability. While the IRS has thus far failed to deliver several important projects with which taxpayers are not directly involved, it is important to note they have had some notable successes. The IRS has made progress on applications such as improved telephone service and a suite of e-services to tax practitioners. For the first time, large businesses and corporations can electronically file. In addition, taxpayers can access refund and Advance Child Tax Credit information from the irs.gov website. The IRS's business systems modernization expenditure plan provides more detail on this request.

In addition, IRS will work to improve customer service by making filing easier; providing top quality service to taxpayers needing help with their return or account; and providing prompt, professional, improved taxpayer access and helpful treatment to taxpayers in cases where additional taxes may be due.

The provisions of the Trade Act of 2002 (P.L. 107-210) chartered the Treasury Department (through the IRS) with establishing and implementing a new health coverage tax credit program in 2003. This program provides a refundable tax credit to eligible individuals for the cost of qualified health insurance for both the individual and qualifying family members. The request provides $35 million to continue implementation and operation of the Health Insurance Tax Credit Program.

The Alcohol and Tobacco Tax and Trade Bureau (TTB) was created when the Homeland Security Act of 2002 divided the Bureau of Alcohol, Tobacco and Firearms into two agencies. Our FY 2005 request includes $81.9 million for TTB: $58.3 million to support the Collect the Revenue function, and $23.5 million to Protect the Public, both of which will facilitate their efforts in collecting $14.6 billion in revenue from the alcohol and tobacco industries and monitor alcohol beverages in the marketplace to detect contamination and adulterated products. Their focus this coming fiscal year is to promote voluntary compliance of existing regulations and to protect the consumer through efficient and effective service.

Key to the U.S. Government's management of financial systems is the Financial

Management Service (FMS), whose mission is to provide central payment services to Federal program agencies, operate the Federal government's collection and deposit systems, provide Government-wide accounting and reporting services, and manage the collection of delinquent debt. The FY 2005 request of $231 million for FMS includes legislative proposals to improve and enhance opportunities to collect delinquent debt through FMS' debt collection program. The proposals would: eliminate the 10-year limitations period applicable to the offset of federal non-tax payments to collect debt owed to federal agencies; increase amounts levied from vendor payments (from 15 percent to 100 percent) to collect outstanding tax obligations; allow the Secretary of the Treasury to match information about persons owing delinquent debt to the federal government with information contained in the Department of Health and Human Service's National Directory of New Hires; and allow the offset of federal tax refunds to collect delinquent state unemployment compensation overpayments.

The Bureau of the Public Debt (BPD) continues its management and improvement of federal borrowing and debt accounting processes. BPD will provide vital support to the processing of applications and the operation of systems used for re-enforcing its mission of providing quality debt management services to financial institutions, individuals, foreign governments, and over 200 government trust funds.

The activities of the United States Mint and the Bureau of Engraving and Printing (BEP) are vital to the health of our Nation's economy. These agencies share the responsibility for ensuring that sufficient volumes of coin and currency are consistently available to carry out financial transactions in our economy. Treasury, Mint and BEP will deliver a study to Congress regarding options to merge and/or streamline operations by consolidating certain functions and sharing costs between the Mint and the BEP.

Fighting the War on Terror and Safeguarding our Financial Systems

Our goals in preserving the integrity of U.S. financial systems include ensuring that the U.S. financial system and access to U.S. goods and services are closed to individuals, groups and nations that threaten U.S. vital interests, ensuring that these systems are kept free and open to legitimate users while excluding those who wish to use the system for illegal purposes, and ensuring that the financial systems will continue to operate without disruption from either natural disaster or manmade attacks. To support such efforts, the President has requested $250.9 million for FY 2005.

The Administration announced the creation of the Office of Terrorism and Financial Intelligence (TFI) within the Department of the Treasury on March 8, 2004, and, while the office was in the early planning stages, we were not able to specifically include it when the President's Budget was submitted to Congress. TFI will lead Treasury's efforts to sever the lines of financial support to international terrorists and will serve as a critical component of the Administration's overall and long-term effort to keep America safe from terrorist machinations.

TFI will consolidate in one office financial intelligence expertise and Treasury's Executive Office for Terrorist Financing and Financial Crime (EOTF/FC). The Executive Office for Terrorist Financing and Financial Crime (EOTF/FC) was established by Treasury in March of 2003 and charged with policy oversight of FinCEN and OFAC as well as providing guidance to the IRS-Criminal Investigation Division (IRS-CI). The creation of the Executive Office for Terrorist Financing and Financial Crime resulted in a single lead office in Treasury for fighting the financial war on terror and combating financial crime, enforcing economic sanctions against rogue nations, and assisting in the ongoing hunt for Iraqi assets. Combining the functions of EOTF/FC and its strategic goals to combat terrorist financing, rogue regimes and other illicit financial activities with a robust intelligence analysis component will improve the ability of Treasury to meet the U.S. government's needs to identify, act, and enforce its policy initiatives.

The new office will be staffed by current and recently authorized Treasury employees and will integrate employees from the component offices, as well as drawing from other Departmental staff. If approved by Congress, Treasury will also be able to hire additional employees for these functions in FY 2005. In addition, the Administration recently sent up an amendment to the President's Budget that proposes to eliminate the staffing and funding floor for the Office of Foreign Assets Control to allow the President and me to have full discretion in allocating

Departmental Office resources in the critical effort to disrupt terrorist financing. This flexibility is even more important in the context of the new TFI office. Barring unforeseen circumstances, the Department has no plans to request additional funds for this office during either the FY 2004 or FY 2005 appropriations process. That said, we believe that through a combination of prudent and targeted use of resources, Treasury will be able to spend up to an additional $2 million on staffing and other start-up needs of TFI during the rest of the current fiscal year. We anticipate that we will be able to bring on board up to 15 new personnel during the remainder of the fiscal year. The Department is committed to working with Congress as we move through the process of setting up this new office, in full agreement with the guidelines that accompany the funding flexibilities that the Congress has generously provided us.

Looking forward to the next fiscal year, we have not made firm decisions about how much money we will devote to the new office. We will evaluate our needs, and we are prepared to make the hard decisions about how to allocate our limited resources. Fighting the war on terror is a priority of the President and of this Department -- and we will spend whatever we need to carry out our duties in a responsible manner. And, of course, we will work with the Congress in making those decisions.

The Executive Office for Terrorist Financing and Financial Crime develops and implements U.S. government strategies to combat terrorist financing domestically and internationally and develops and implements the National Money Laundering Strategy as well as other policies and programs to fight financial crimes. The office is also responsible for representing the Treasury and the U.S. government internationally in fora related to terrorist financing and money laundering as well as participating in the Department's development and implementation of U.S. government policies and regulations in support of the Bank Secrecy Act and the USA PATRIOT Act. The President's budget request for FY 2005 provides additional funds to support this mission, including a 14 percent funding increase and a 36 percent staffing boost.

The Office of Foreign Assets Control (OFAC) also plays a central role in the Treasury Department's efforts to disrupt financing of terrorist activities. Only days after September 11, 2001, Treasury helped draft and implement Executive Order 13224, which invoked Presidential authority contained in the International Emergency Economic Powers Act and froze the assets of 29 entities and individuals linked to Osama bin Laden and his al Qaeda network. Since then, OFAC research and investigation helped identify between 200 and 300 additional entities and individuals as Specially Designated Global Terrorists under the Order. Since September 2001, Treasury, through OFAC, and our allies have frozen over $139 million in terrorist assets and vested and returned more than $2.6 billion of frozen Iraqi assets.

The President's FY 2005 request also includes $64.5 million for the Financial Crimes Enforcement Network (FinCEN) to enhance its ability to fight the war on terror and combat financial crimes such as money laundering. Its mission to safeguard the U.S. financial systems from the abuses imposed by criminals and terrorists and to assist law enforcement in the detection, investigation, disruption and prosecution of such illicit activity is accomplished through its statutory role as the administrator of the Bank Secrecy Act (31 C.F.R.) FinCEN issues and enforces regulations that require a wide gamut of financial institutions to implement anti-money laundering programs and report transactions that are indicative of money laundering, terrorist financing and other financial crimes, thus providing a wealth of information to assist law enforcement, both domestic and international, in pursuing such crimes. FinCEN also ensures that the information collected under these regulations is made fully accessible to law enforcement and the regulatory community in a secure manner and provides both tactical and strategic analysis to a variety of customers. In addition, FinCEN is the Financial Intelligence Unit (FIU) for the United States and has been central in the development of a consortium of FIUs around the globe that permits fast and effective sharing of financial intelligence on an international scale.

The IRS's Criminal Investigative Division (IRS-CI) also plays a key role in investigating financial crimes. The request supports the unique skills and expertise of IRS-CI agents in investigating tax fraud and financial crimes not only support tax compliance, but also benefit the war on terror and our efforts to root out financial crimes.

In addition, the Office of Critical Infrastructure Protection and Compliance Policy leads our efforts to safeguard the financial infrastructure. This Office works closely with the Department of Homeland Security, other federal agencies, and the private sector to safeguard our infrastructure. That is essential, given that the majority of the critical financial infrastructure of the United States is owned and operated by the private sector. The financial system is the lifeblood of our economy, and this Office leads our efforts to keep it safe.

Ensuring Professionalism, Excellence, Integrity and Accountability in Management of Treasury

The President has requested $229.6 million for ensuring proper stewardship of the Department. Included in this request is $14.2 million for the Department's Office of Inspector General (OIG) and $129.1 million for the Inspector General for Tax Administration (TIGTA).

The 1988 amendments to the Inspector General Act of 1978 created the OIG to conduct audits and investigations relating to Treasury programs and operations; to promote economy and efficiency, and detect and prevent fraud and abuse, in such programs and operations; and to notify the Secretary and Congress of problems and deficiencies in such programs and operations.

The Internal Revenue Service Restructuring and Reform Act of 1998 created the Inspector General for Tax Administration (TIGTA) to oversee operations at the Internal Revenue Service (IRS). TIGTA promotes the public's confidence in the tax system by assisting the IRS in achieving its strategic goals, identifying and addressing its material weaknesses, and implementing the President's Management Agenda. Further, TIGTA undertakes investigative initiatives to protect the IRS against threats to systems and/or employees.

To maximize efficiencies and effectiveness, the Administration has proposed to merge the Treasury Inspector General and the Treasury Inspector General for Tax Administration into a new Inspector General office, called the Inspector General for Treasury. The new organization will have all of the same powers and authorities as its predecessors have under current law. We will work with the Congress to move this legislation forward.

Also included in this request is an increase of $10.8 million for a host of modernization activities of our systems including IT Governance, E-Government, operational security, and Treasury enterprise architecture.

Foundation for Success – The President's Management Agenda

As mentioned earlier, following the movement of the law enforcement bureaus to the Departments of Homeland Security and Justice, Treasury restructured and refocused its strategic goals and objectives based on the five initiatives of the President's Management Agenda (PMA). Treasury developed and issued its new Strategic Plan, which linked intricately with each of the five initiatives of the PMA. This new strategic vision, coupled with the efforts underway in the PMA, provides the mechanism and focus for continuous improvement throughout Treasury and its bureaus.

In FY 2003, Treasury achieved many significant milestones in implementing the President's Management Agenda. Specific accomplishments included:

- Over the past 18 months, Treasury has worked to draft the first-ever Department-wide Human Capital Strategic Plan, which addresses the Standards for Success as issued by the Office of Personnel Management (OPM) and the Office of Management and Budget (OMB). Treasury incorporated human capital into its strategic planning and budget formulation and execution processes, and the plan will guide future efforts in areas such as workforce and succession planning, diversity, performance management, and managerial accountability.
- In competitive sourcing, Treasury completed 3 full competitions, over 20 streamlined competitions, and currently has studies involving approximately 4,500 positions in various phases of completion.
- In budget and performance integration, Treasury revised the performance reporting requirement to facilitate review and assessment of bureaus' key

performance data. Treasury also restructured some of the bureaus' budget activities to reflect alignment with the new strategic plan and the full cost of achieving results.

Treasury also maintained its government-wide lead in accelerated financial reporting. The Department implemented a three-day monthly close and successfully issued its FY 2003 Performance and Accountability Report on November 14, 2003, two and one-half months ahead of the official deadline.

Treasury will continue to work closely with OMB and other stakeholders to make improvements in implementing the initiatives set forth in the President's Management Agenda.

The President's Six Point Economic Growth Plan

At the beginning of my testimony I talked about what the Treasury Department does to support our strategic goal of encouraging a prosperous and stable U.S. economy. I would also like to talk about our efforts across the Administration to promote economic growth as embodied by President's six-point plan for growth.

That includes making health care more affordable with costs more predictable.

We can do this by passing Association Health Plan legislation that would allow small businesses to pool together to purchase health coverage for workers at lower rates.

We also need to promote and expand the advantages of using health savings accounts ... how they can give workers more control over their health insurance and costs.

And we've got to reduce frivolous and excessive lawsuits against doctors and hospitals. Baseless lawsuits, driven by lottery-minded attorneys, drive up health insurance costs for workers and businesses.

The need to reduce the lawsuit burden on our economy stretches beyond the area of health care. That's why President Bush has proposed, and the House has approved, measures that would allow more class action and mass tort lawsuits to be moved into Federal court -- so that trial lawyers will have a harder time shopping for a favorable court.

These steps are the second key part of the President's pro-jobs, pro-growth plan.

Ensuring an affordable, reliable energy supply is a third part.

We must enact comprehensive national energy legislation to upgrade the Nation's electrical grid, promote energy efficiency, increase domestic energy production, and provide enhanced conservation efforts, all while protecting the environment.

Again, we need Congressional action: we ask that Congress pass legislation based on the President's energy plan.

Streamlining regulations and reporting requirements are another critical reform element that benefits small businesses, which represent the majority of new job creation: three out of every four net new jobs come from the small-business sector! Let's give them a break wherever we can so they're free to do what they do best: create those jobs.

Opening new markets for American products is another necessary step toward job creation. That's why President Bush recently signed into law new free trade agreements with Chile and Singapore that will enable U.S. companies to compete on a level playing field in these markets for the first time -- and he will continue to work to open new markets for American products and services.

Finally, we've got to enable families and businesses to plan for the future with confidence.

That means making the President's tax relief permanent.

Rate reductions, the increase in the child tax credit and the new incentives for small-business investment – these will all expire in a few years. The accelerated rate reductions that took effect in 2003 will expire at the end of this year. Expiration dates are not acceptable – we want permanent relief.

The ability of American families and businesses to make financial decisions with confidence determines the future of our economy. And without permanent relief, incentives upon which they can count, we risk losing the momentum of the recovery and growth that we have experienced in recent months.

The tax relief is the key stimulus for increased capital formation, entrepreneurship and investment that cause true economic growth.

Conclusion

Mr. Chairman, I look forward to working with you, members of the Committee, and your staff to maximize Treasury's resources in the best interest of the American people and our country as we move into FY 2005. I am hopeful that together we can work to make this Department a model for management and service to the American people.

Thank you again for the opportunity to present the Department's budget today. I would be pleased to answer your questions.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
JS-1672

MEDIA ADVISORY
Secretary Snow to Visit Ohio on Friday and Saturday

Treasury Secretary John W. Snow will visit Columbus and Gambier, Ohio on Friday, May 21 and Saturday, May 22 to visit with local business leaders and speak at Kenyon College's commencement.

The Secretary will highlight the President's efforts to strengthen the economy and create new jobs. As a result of the President's tax legislation in 2001 and 2003, 4.4 million Ohio taxpayers will pay lower income taxes in 2004. Nearly 860,000 business taxpayers in Ohio are able to use their tax savings to invest in new equipment, hire additional workers, and increase pay.

In Columbus on Friday, Secretary Snow will tour the facility of the Ohio Transmission Corporation, 1900 Jetway Blvd., followed by a roundtable discussion with local business leaders and a press availability at the same location. Information on the Ohio Transmission Corporation can be found at www.otpnet.com.

On Saturday, the Secretary will deliver the commencement address at Kenyon College in Gambier.

The following events are open to the media:

Friday, May 21
2:00 pm
Tour of Ohio Transmission Corporation
1900 Jetway Blvd.
Columbus, OH
**** Media must arrive by 1:00 pm with their media credentials**

2:30 pm
Roundtable Discussion with Local Business Leaders
Ohio Transmission Corporation
1900 Jetway Blvd.
Columbus, OH

3:30 pm
Press Availability
Ohio Transmission Corporation
1900 Jetway Blvd.
Columbus, OH

Saturday, May 22
10:00 am
Commencement Address to Kenyon College Graduating Class of 2004
Kenyon College
Sam Mather Lawn (rain location: Ernst Center)
Gambier, OH

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
js-1673

Kansas Makes Federal Health Coverage Tax Credit Available

Today, Treasury Secretary John Snow applauded Governor Kathleen Sebelius for signing legislation that allows the state's Uninsurable Health Insurance Plan to qualify for the Health Coverage Tax Credit Program (HCTC). The program will help cover the cost of health insurance premiums for many Kansas residents.

"I would like to thank the Republicans and Democrats in the legislature who voted for this legislation and Governor Sebelius for signing it," stated Treasury Secretary John Snow. "I would also like to thank Insurance Commissioner Sandy Praeger, Department of Human Resources Secretary Jim Garner and other interested parties in Kansas who have worked so hard to make the Health Coverage Tax Credit program available to over 1,400 workers and their families. I commend them for their leadership in enacting legislation that makes the state's Uninsurable Health Insurance Plan available to those eligible for TAA benefits. The HCTC program is a real innovation in tax policy, one that we hope will lead the way for other innovations that help real people obtain the health care coverage that they need in a flexible and reliable way. We want to ensure that those who qualify for the credit get the help they need as quickly as possible."

The Trade Adjustment Assistance Act President Bush signed into law in 2002 included the new Health Coverage Tax Credit (HCTC). Recipients can receive the HCTC either in advance, to help pay qualified health plan premiums as they come due, or in a lump sum when they file their federal tax returns. The HCTC advance payments program began nationally in August 2003. This program provides an advanced payment of 65% of the premium cost for a qualified health plan for individuals who are eligible to receive Trade Adjustment Assistance (TAA) benefits or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

In order to receive the credit, eligible individuals must enroll in qualified health insurance, such as a COBRA health plan or State Qualified Health Plan (SQHP). Thirty-six states and the District of Columbia have SQHPs that will enable more than 205,000 of those potentially eligible for the HCTC to purchase health coverage. Nationwide, there are nearly 250,000 individuals potentially eligible for the HCTC.

For more information on a particular state and the health insurance programs that qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: HCTC.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 21, 2004
JS-1674

Treasury Releases Technical Clarification Relating to U.S.-Japan Income Tax Treaty

A Record of Discussions with respect to the new U.S.-Japan Income Tax Treaty was signed on May 19th in Tokyo by U.S. and Japanese officials. The Record of Discussions provides clarification regarding the application of clause 3(c)(iv) of Article 11 of the Treaty, relating to the qualification of financial institutions for elimination of source-country withholding taxes on interest income.

Article 11 of the Treaty generally permits the source country to impose withholding taxes on interest at a maximum rate of 10 percent. However, paragraph 3(c) of Article 11 of the Treaty provides for the elimination of source-country withholding tax on interest received by banks (including investment banks), insurance companies, and registered securities dealers. Paragraph 3(c) of Article 11 also provides for the elimination of source-country withholding tax on interest received by other enterprises that meet asset and liability conditions set forth in clause (iv) that are characteristic of financial businesses. This provision is intended to ensure comparable treatment of different types of financial businesses. The particular language relating to asset and liability conditions for eligibility for the elimination of interest withholding tax is unique to the new U.S.-Japan Income Tax Treaty. The document signed on May 19th memorializes the intended technical application of these conditions in the context of a financial business that operates through a multiple entity group.

A copy of the Record of Discussions is attached.

-30-

REPORTS

- Record of Discussions

RECORD OF DISCUSSIONS
[WITH RESPECT TO THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF JAPAN FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON NOVEMBER 6, 2003]

The representatives of the Government of the United States of America and of the Government of Japan wish to confirm their intentions regarding application of clause (iv) of subparagraph (c) of paragraph 3 of Article 11 of the Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed at Washington on November 6, 2003. It is understood that, in the case of an enterprise that derives more than 50 percent of its liabilities from the issuance of bonds in the financial markets or from taking deposits at interest, the conditions with respect to the assets described in that clause will be considered to be satisfied, if they are satisfied on the basis of the consolidated financial statement of that enterprise prepared for financial disclosure or other regulatory purposes related to such debt issuances, which would take into account on a consolidated basis the assets of that enterprise and the assets of subsidiary companies consolidated with that enterprise for such purposes. The preceding sentence will not apply if on a consolidated basis 50 percent or more of the liabilities of the enterprise and the liabilities of the subsidiary companies consolidated with the enterprise for such purposes are derived other than from the issuance of bonds in the financial markets or from taking deposits at interest.

DONE in duplicate at Tokyo this nineteenth day of May, 2004, in the English and Japanese languages.

James Zumwalt
Minister Counselor
for Economic Affairs
Embassy of
the United States of America

Shingo Yamagami
Director,
Second North America Division
Ministry of Foreign Affairs
Japan

Barbara M. Angus
International Tax Counsel
Department of the Treasury
United States of America

Masatsugu Asakawa
Director,
International Tax
Policy Division
Ministry of Finance
Japan

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
js-1675

Under Secretary Taylor to Travel to Four Nations in Sub-Saharan Africa: Uganda, Nigeria, Benin and Ghana

John Taylor, Treasury Under Secretary for International Affairs, will focus on development in sub-Saharan Africa when he visits four nations May 24-31.

Taylor will begin his visit in Kampala, Uganda on Tuesday, May 25 where he will lead the United States delegation to the annual meetings of the African Development Bank (ADB). The United States is supporting the increased use of grants to finance development projects from the ADB's African Development Fund. Taylor will host a meeting of African officials to discuss the benefits of multilateral development bank grants for greater development effectiveness. Taylor's schedule in Uganda will include a panel discussion of strategies to develop mortgage markets in Africa. He will also meet with officials from the government of Uganda and hold a series of bilateral meetings with official representatives from African nations.

On Wednesday, May 26 Taylor will travel to Abuja, Nigeria to attend a conference of the Money Market Association of Nigeria. On Thursday, May 27 he will present the keynote address at the conference. Taylor's remarks will focus on the importance of sound monetary policy for development. While in Abuja, Taylor will also attend a USAID-sponsored roundtable on the development of the Nigerian mortgage market where he will announce an innovative new program aimed at microfinance for housing and small business.

Benin and Ghana were recently named as countries eligible to receive funding from President Bush's Millennium Challenge Account. On Friday, May 28 Taylor will visit Cotonou, Benin to meet with government officials and representatives from the donor community to discuss development efforts underway in Benin and the development of projects for possible MCA funding. Before departing for Ghana, on Saturday morning Taylor will visit two HIV/AIDS projects funded by the International Development Association (IDA) – the World Bank's financing arm for the poorest countries.

Taylor previously visited Accra, Ghana in May 2002. This return trip will provide an opportunity to assess Ghana's progress in reaching its goals for poverty alleviation and increasing economic growth. On Sunday, May 30, Taylor will visit two markets and a completed road project that were supported by IDA funding. He will also meet with local officials to discuss development issues and to view new wells.

On Monday, May 31, Taylor will meet with senior officials of the government of Ghana to assess the country's progress in implementing their program to generate economic growth. In the afternoon he will deliver remarks at an event hosted by the Institute of Economic Affairs that will be attended by government officials, academics, and representatives from donor countries and non-governmental organizations.

Under Secretary Taylor will depart Accra Monday evening and return to Washington on Tuesday, June 1.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 21, 2004
JS-1676

Media Advisory:
Assistant Secretary Wayne Abernathy to Lead Identity Theft Workshop, "Fighting Identity Theft: Outsmarting the Crooks" in Kansas City, Missouri

Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy will lead a workshop, "Fighting Identity Theft: Outsmarting the Crooks," on May 26 at Penn Valley Community College in Kansas City, MO. Catherine A. Allen, CEO of BITS, a non-profit consortium of 100 of the nation's largest financial institutions, will co-host the event.

Identity thieves strike an estimated 10 million Americans a year, costing them $5 billion and countless hours to restore their good names. Recently, so-called "phishing" attacks have skyrocketed, as identity thieves try to trick consumers into submitting personal information to "spoofed" Web sites.

Experts from the front lines of the battle, including financial institution, law enforcement, and innovative technology firm representatives, will provide consumers the needed information to protect themselves and fight identity theft.

Assistant Secretary Abernathy will highlight the tools available to consumers through the Fair and Accurate Credit Transactions (FACT) Act. Abernathy also will moderate a panel discussion about the ways in which financial institutions are helping consumers fight identity theft. A second panel moderated by Camden Fine, President and CEO of the Independent Community Bankers of America, will detail how law enforcement tracks and prosecutes an identity theft case. Allen will outline several important initiatives of the financial services industry and will host the third panel, which will highlight some innovative technologies that help safeguard and detect identity theft.

WHO: Assistant Secretary Wayne A. Abernathy, the Department of the Treasury
Catherine A. Allen, CEO, BITS
Camden Fine, President and CEO, Independent Community Bankers of America
Distinguished guests from the front lines of the fight against identity theft

WHAT: A workshop on new tools for consumers to use in the fight against identity theft, with expert advice from leaders of financial institutions, law enforcement, and technology companies.

WHEN: Wednesday, May 26, 2004
9:30 a.m. – 12:15 p.m. CDT

WHERE: Penn Valley Community College
3201 SW Trafficway
Kansas City, MO 64111

CONTACTS: Media planning to cover the event should contact Treasury's Office of Public Affairs at 202/622-2960.

Individuals interested in attending the workshop should contact Keviar Warner at keviar@fsround.org or 202-589-2435.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 21, 2004
JS-1677

Officials from Treasury and Agriculture Departments Present $61.7 million in Economic Development Tax Credits in Iowa to Help Low-Income Communities

Director of Treasury's Community Development Financial Institutions (CDFI) Fund, Arthur A. Garcia, and Senior Advisor to the Agriculture Department Secretary, Thomas C. Dorr, today presented $61.7 million in New Market Tax Credits for business and economic development in low-income communities. The award was presented to Rural Development Partners, LLC at the BECON Energy Conversion Center in Nevada, Iowa.

The Treasury Department announced on May 6 that 62 organizations have been selected to receive a total of $3.5 billion in tax credit allocations through the second round of the New Market Tax Credit (NMTC) Program.

The New Market Tax Credit program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most. The NMTC Program, established by Congress in December 2000, permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The credit provided to the investor totals 39 percent of the initial value of the investment and is claimed over a seven-year credit allowance period. The 62 organizations receiving tax credit allocations this year were selected through a competitive application and rigorous review process.

The NMTC Program is administered by Treasury's Community Development Financial Institutions Fund. The CDFI Fund anticipates that applications for the third round of the NMTC Program will be available during the summer of 2004. A complete list of 2004 New Markets recipients and additional information can be found on the CDFI Fund's Web site: www.cdfifund.gov.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 21, 2004
JS-1678

Updated Final Schedule for Finance Ministers' Pre-Summit Meeting

The meeting of the Finance Ministers preceding the Group of 8 Summit will take place May 22-23, 2004 at the Waldorf-Astoria Hotel, 301 Park Avenue, New York, NY The following is a final schedule of events:

SATURDAY, MAY 22

Finance Ministers' Meeting
Waldorf-Astoria Hotel
Outside of the Empire Room
301 Park Ave.
New York, NY
7:00 PM EDT
Pool photo at conclusion of event with pool reporter

SUNDAY, MAY 23

Meetings
Waldorf-Astoria Hotel
9:00 am EDT
Pool coverage; national photographers as requested by country

Group Photo
Waldorf-Astoria Hotel
12:00 pm EDT
Group photo is open photo with pool reporter; participating cameras should meet outside Promenade Suite A, ground level at Park Ave. entrance, at 11:00 am

U.S. Press Conference Held by U.S. Treasury Secretary John Snow
Waldorf-Astoria Hotel, Astor Salon
2:15 pm EDT
Open to all media with appropriate media identification
Will include release of communiqué and Secretary Snow's written statement
All media equipment (including tape recorders) must be pre-set for security sweeps by 1:15 pm

**** There are no bilateral meetings expected at this time.**

** The Treasury Department will not issue event-specific accreditation badges to the media. Members of the media should wear the press credentials issued to them by their media organization. Members of the media participating in press pools will be given temporary badges to wear while performing that duty.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

May 22, 2004
JS-1679

The Honorable John W. Snow
Prepared Remarks
Kenyon College Commencement
Gambier, OH

Thank you so much for having me here on what is one of the most significant days of your lives... and of your parents' lives.

For you, today is about the future, and the enormous possibilities it holds.

For your parents, today is also about the future... one without tuition payments.

So congratulations to one and all.

I promise you that the future of my remarks is a short one. I'll offer you a few thoughts and then let you get those diplomas that you have worked so very hard for.

I've returned to Kenyon today with three things for the class of 2004:

* a reminder of your place in history,

* a way of looking at your education and what it means,

* and a little bit of advice about living life to its fullest.

First, your place in history.

You are graduating at a time - and in a place - of unparalleled opportunity.

This great country has faced difficult times while you were studying here at Kenyon, and your graduation is well timed with our economy's recovery, the full return of its strength.

While we will always bear the emotional scars of September 11th, we no longer bear the economic ones.

We will also never forget the lessons we learned from the corporate greed and scandals that were growing in the 90s and rocked our markets and hurt so many workers early in this decade. But we have moved on from those days as well in a direction that places a premium on accountability and ethics in business.

We've come through these challenges in a way that only America can. Our free market makes us so resilient, and today all economic indicators are very strong. Most importantly, jobs are being created at a very strong pace 1.1 million over the past eight months.

With the knowledge and skills that you offer, the job market is ripe for you right now.

Your place in history is also unique because we have also been reminded, while you have been a student here, of the fact that the freedom we enjoy in this country is unique, and it is precious.

As a nation we have been more exposed to the tyrannies that existed in Afghanistan and Iraq. We have realized what it means to live in a place where girls cannot go to school and women cannot realize their personal or professional dreams.

We have been reminded that our freedom vast, it is precious, and it is the envy of the world.

You should let the fact of our freedom thrill you. You are as free, right now, as any human being on this earth. The openness of our markets and our society mean your creativity will be unencumbered.

You are so much more fortunate than your counterparts across the globe   those graduating from universities today in France, Germany, and Italy for example, are entering into anemic economies where job creation is limited.

I cannot tell you what the jobs of the future will be here in this country, but I can promise you that they will be different than they are today, and that the spirit of innovation and entrepreneurship this country has in such abundance will keep those jobs coming, and keep them interesting. Entrepreneurship, after all, is creativity in action.

I'll be talking about this topic with Britain's Chancellor of the Exchequer Gordon Brown on Monday. The UK shares our respect and appreciation for the contributions of entrepreneurs, so we'll be working on ways to encourage that spirit in both the UK and U.S.

As the beneficiaries of a liberal arts education, you will be part of the critical thinking and creativity that will lead to the jobs of the future. I have always seen a linkage between the spirit of the entrepreneur, the qualities of entrepreneurship, and the qualities of a mind nurtured and inculcated by a first-rate liberal arts education, the sort that you have been privileged to have here at Kenyon.

Think about this: When I was a student here at Kenyon 40 years ago, no one had heard of the internet, cell phones or instant messaging. We didn't download our music to an iPod... we put a needle on a round piece of vinyl, and we thought that was pretty good!

Now we can't imagine our lives without the technology we utilize every day.

Progress is a fantastic thing, and free societies enjoy all of its fruits.

Your superior education has given you something else to enhance your life in a free society. As Kenyon graduates, you now have some of the critical tools and skills that will help you reach your goals.

In short: Today is an excellent time to leave this campus, for the options open to you are nearly limitless.

The second thing that I offer to you this morning is a way of looking at your Kenyon education. What does it mean, this diploma, these years of classes, papers and exams?

This is very important: Education is not the knowledge you gain. It is the ability to learn.

Your years at Kenyon have developed your ability to learn, to look hard at questions and have a disciplined mind.

An educated person has a spirit of inquiry... and that is far more important than a body of knowledge. It is similar to that entrepreneurial spirit that I spoke of a moment ago... and it is something that our society cherishes... and this is fortunate for all of us.

Life will be full of uncertainties; I would be lying if I told you differently. And in the face of uncertainty there are no proven rules no algorithm one can turn to. But your education here will help you deal with those uncertainties.

Because ultimately one must find answers through that spirit of inquiry, self-reliance and self-confidence - the things that lie at the heart of a good liberal arts education.

You're now equipped to enter into the unknown and use your critical mind to determine the best course.

Your education here has exposed you to so many different areas - from music to physics, poetry to psychology - you have by now learned how all facets of this life are somehow connected, and that will help you draw conclusions and make critical decisions.

This leads me to the third and final segment of my speech: my advice to you. Because those critical decisions do start now.

Take your ability to learn and decide to use it pursuing a lifetime of learning.

Tackle each new job - you are likely to have many over the course of your career with that spirit of inquiry that you have honed here at Kenyon. Learn about each place that you visit, and each person that you meet, each situation that you encounter.

Learn from both conflict and harmony, from your own successes and failures.

And please don't forget to learn about the communities in which you live, wherever they might be. The best way to do this is to get involved in those communities as a volunteer, and to give of yourself to your neighbors.

When we help each other, when we love one another, our society is lifted and doors are opened.

This is an essential part of living a truly full life, and of pursuing that path of lifelong learning.

Keep exercising those critical minds of yours, wherever you go. Make sure your mind and your heart work in partnership. If you do this, you will make the Kenyon community as proud as I know your parents are of you today.

Thank you again for having me here. Congratulations on your achievement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 21, 2004
JS-1680

The Honorable John W. Snow
Prepared Remarks
Ohio Transmission and Pump Company
Columbus, Ohio

It's great to be here in my home state of Ohio, and great to be here at the Ohio Transmission and Pump Company.

I'm delighted that this business has benefited so much from the President's economic policies – you've grown and you're now going to be able to hire more people. You are one of nearly 860,000 business taxpayers here in Ohio who can use their tax savings from the President's tax cuts to invest in new equipment, hire additional workers, and increase pay.

It's businesses like this that create jobs, and that is the President's top economic priority – that's why his tax cuts focused on helping small business.

Ohio lost more than its fair share of jobs during our recent recession. That's why the news that almost 35,000 new jobs have been created in Ohio since December of 2003 is so welcome. The Ohio economy created 4,300 jobs in April – that's terrific news for 4,300 of Ohio's workers and their families.

Your unemployment rate is at 5.8 percent right now, so we're not satisfied by any means. Ohioans need jobs; we need to lower that rate.

Manufacturing jobs are very important to this state, and those jobs were hardest hit during our time of economic recession. We've seen modest gains in that area on a national basis since we've been in economic recovery, with 21,000 new manufacturing jobs created in April – the third straight month of job creation. While we still are not satisfied with the rate of recovery in the manufacturing industry, the signs are pointing in a positive direction.

Nationally, the total jobs increase – in all industries – since August has been 1.1 million. The unemployment rate, which is down substantially from its peak last summer, fell in April and is below the average of each of the past three decades.

That's good news, but it needs to get even better. Especially here in Ohio.

I remain optimist, and extremely hopeful for Ohioans who are looking for work today. There is no doubt that our economy is doing very well, and job creation does follow economic growth. It's never fast enough for any of us, but it does come.

I'm optimistic because over the past nine months, we've seen the best overall growth in almost 20 years; GDP has been averaging an outstanding annual rate of 5.5 percent over the past three quarters.

Business spending has rebounded. Business and consumer confidence are up, and there are signs that the labor market is also beginning to create better-paying jobs. Our housing industry is extremely strong, with homeownership at an all-time high, and this is something to be very proud of, as a nation.

It's clear that American families and small businesses have benefited from the lowered burden of taxation brought about by President Bush's tax cuts. The natural strength and resilience of our free-market economy has proven itself once again.

The President's tax cuts provided the relief and the stimulus that American consumers and job-creators needed.

As a result, people are finding jobs and seeing their paychecks increase, and that kind of security is the President's top economic priority

When we lift the weights that hold it down, our economy soars. That's why the most important thing we can do going forward is to keep it unencumbered by making the President's tax cuts permanent.

We can't stop our progress now – the working people of Ohio need this growth to continue, because we need the jobs it will create.

Thank you for having me here today, and thank you for the work you do to make our economy the strongest in the world.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 21, 2004
JS-1681

Remarks by
Michael A. Dawson
Deputy Assistant Secretary of the Treasury
For Critical Infrastructure Protection & Compliance Policy
Delivered to Lorain County Community College
Lorain, Ohio
Fighting Identity Theft: Challenges and Opportunities in Implementing the Fair and Accurate Credit Transactions Act of 2003

Identity theft is one of the fastest growing crimes in America. According to a November 2003 study by the Federal Trade Commission, 10 million Americans were victims of identity theft in 2002. Identity theft cost American consumers $5 billion in 2002. It cost financial institutions $50 billion.

I don't have to tell you that identity theft is right here, in Ohio. Comprehensive state by state data is hard to come by. But we have some idea from a January 2004 report by the Federal Trade Commission on the number of identity theft complaints submitted to its consumer sentinel database. The Cleveland-Lorain-Elyria metropolitan area ranked 21st in the nation among metropolitan areas with the most identity theft complaints.

The President recognized the growing threat of identity theft. He called it, "one of the most harmful abuses of personal information." For that reason, the President tasked Secretary Snow and the Department of the Treasury with identifying new tools in the fight against identity theft. We, in turn, consulted with financial institutions, technology companies, regulators, and victims. On June 30, Secretary Snow announced the result: a baker's dozen of proposals to help fight identity theft and renew national uniform standards that govern our national consumer credit reporting system. With some exceptions, we didn't invent the ideas in the proposals. These didn't come from bureaucrats in Washington. They came from you: from financial institutions, technology companies, consumers, and, most importantly, from victims.

Congress showed great leadership in this battle. Chairman Oxley, Congressman Bachus, and Chairman Shelby held extensive hearings documenting the scope of the problem of identity theft and the economic importance of national, uniform consumer credit reporting standards.

Their leadership, and the leadership of many of their committee members, culminated in the Fair and Accurate Credit Transactions Act of 2003, which passed the Congress with overwhelming bipartisan support. I should add that Ohio's congressional delegation was crucial to getting this Act passed. Chairman Oxley, Congressmen Gillmor, LaTourette, Ney, and Tiberi all provided strong leadership in the House Financial Services Committee.

The President signed the FACT Act on December 4. It was an important step toward strengthening our economy. As the President said, "reliable access to credit and capital is essential to growth and prosperity." And the FACT Act, as the President said, "confronts the problem of identity theft." For example:

- Consumers will be able to get a copy of their credit report free of charge every year so that they can correct inaccuracies and spot fraud early in the crime spree.

- With one phone call, a consumer will be able use the national security alert system established under the law to put merchants and lenders on their guard that an impersonator is transacting business fraudulently in the consumer's name.

- An Active Duty Alert will permit our active duty service men and women, or their representatives, to alert merchants and prospective creditors that they are away from home for an extended period of time, and potentially vulnerable to fraud.

- Bank regulators will draw up guidelines to identify patterns of identity crime that financial institutions will use to help prevent the crime and protect their customers.

Since passage of the Act and the President's signing, regulators – the FTC, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and, of course, and the National Credit Union Administration – have been hard at work implementing the Act through rules and regulations.

This process is a difficult one. Congress imposed very tight deadlines on the regulators so that the rules would be issued as soon as possible. The issues are difficult and complicated. They are inter-related. There are many moving parts. It is something of an understatement to say that implementation of the FACT Act through regulation presents some challenges.

I believe that we can meet those challenges if we keep two principles in mind. They were the principles that the President talked about when he signed the Act. They were the principles that the Secretary talked about when he announced the Administration's proposals way back on June 30th. They are accessibility and security. As we write the rules, we should keep our eye on expanding access to credit while enhancing the security and accuracy of consumers' personal financial information.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 23, 2004
JS-1682

Statement by U.S. Treasury Secretary John Snow following the Pre-Summit Finance Ministers' Meeting

I was pleased to host Finance Ministers in New York today to prepare for the Annual Summit of G-8 Leaders.

Achieving sustained growth remains a key driver of our discussions. The world economy is strong. Global growth is expanding at more than 4 ¼ % for 2003-2004, the best growth rate in fifteen years. This is excellent news for those represented at our meeting today as well as our neighbors in emerging market and developing countries.

President Bush's economic leadership has put the United States at the forefront of the drive for growth. Nationally, we gained 288,000 new jobs in April, and the nation has added more than 1.1 million new jobs since last August. The unemployment rate has fallen steadily, and now stands at 5.6 percent, down from 6.3 percent last June -- lower than the average unemployment rate of the 1970s, 1980s, and 1990s. Over the past year, the unemployment rate has fallen in 47 of the 50 states. After tax incomes are up by 10% since December 2000 and household wealth is at an all-time high. Economic growth over the last four quarters has been the strongest in two decades.

This pro-growth, pro-jobs agenda is founded in the President's jobs and growth tax relief plan. When we let the American people keep more of what they earn and save, they put that money to good use. They demand more goods and services, which creates demand for new workers. Now that our economy is expanding and adding more jobs, we need to make sure Americans keep their tax relief.

The industrial sector is now clearly on the rise, thanks to strong gains in capital investment, a record level of exports, and a rebuilding of inventories. Industrial output has risen at nearly a 6 percent annual rate over the past ten months and manufacturers have added jobs in each of the past three months. Business sentiment at both large and small firms has rebounded, suggesting the outlook for real growth remains very good.

Policy changes in each of our countries are helping fuel strong global growth. Tax cuts, enhanced work incentives, pension reforms, and strengthened financial sectors – to name a few – are among the key steps taken to help bolster job creation and productivity growth. The strong world economy provides an important opportunity for Leaders to build on these successes through the Agenda for Growth Initiative. We discussed today our plans to implement further structural reforms, including ways to tackle rising healthcare costs, spur saving, reduce regulatory and legal burdens, and support entrepreneurship and innovation.

Tomorrow, Chancellor Gordon Brown and I look forward to hearing from entrepreneurs from both sides of the Atlantic about the critical role that enterprise and innovation plays in economic progress. We will explore the factors that help nurture entrepreneurship, existing impediments to enterprise, and how business and government can work together to address those impediments. These factors are critical to continued prosperity in the U.S. and world economies.

While positive news about the world economy and ambitious plans for solidifying growth dominated our meeting, the recent rise in oil prices was also discussed. Lower oil prices would contribute to our efforts to achieve strong and sustained growth. Higher prices act as a tax on both families and businesses. It is vital that oil producers provide adequate supplies to ensure that prices are at levels that foster strong global economic growth.

Our nation must also address the fundamental energy challenges that have built over time. Three years ago, President Bush submitted to Congress a national energy strategy that would address our long-term energy needs. It called for tax incentives for fuel-efficient hybrid vehicles, more exploration in places like Alaska, and greater use of ethanol, a reliable source of energy produced on our farms.

This national strategy would help make our country less dependent on foreign sources of energy. Yet, these measures have been repeatedly blocked by members of the Senate -- and American consumers are paying the price. Three years is long enough. We urge the Congress to end the delays, and pass comprehensive energy legislation.

Helping generate strong growth in the world economy is critical for helping promote growth and reduce poverty in developing countries. But it is not enough. It is critical to do more to facilitate the role of the private sector in creating jobs and fueling growth in these economies. Other Ministers share this view.

Just as they have played a pivotal role in our own economies, entrepreneurs are a vital resource in developing countries. We know that only businesses – especially small enterprises – can create the jobs necessary to raise standards of living and lift people out of poverty. Ministers pressed for the multilateral development banks (MDBs) to do more to support the development of small business, for instance by enhancing their financial and technical assistance programs. We also urged them to work with bilateral donors and developing countries to develop action plans to address investment barriers and report on progress made. As we have increasingly stressed for all aspects of MDB operations, these plans should reflect clear, results-based objectives.

We emphasized the key role that remittance flows play in supporting households and their potential contribution to development. Together, we are committed to overcoming barriers to the transmission and receipt of these flows, to improving financial education and increasing the range of financial services available – so that remittance flows play as productive a role as possible in these economies.

Economic reform in the broader Middle East and North Africa was a key item on our agenda. In April, we met with regional Ministers and communicated our support for their reform efforts and their priorities for accelerating growth. We are committed to working with these countries to increase economic growth and job creation. Key steps will include improving the region's investment climate, supporting private sector growth, and providing more effective technical assistance. We are supporting reform on economic and financial sector issues through an ongoing policy dialogue. We look forward to discussing these and other shared priorities when we meet with regional Ministers again this fall.

As you know, G-7 Ministers have been conducting a Strategic Review of the IMF and World Bank. We agree that the goals of increasing economic stability and raising economic growth remain valid for these institutions. Nonetheless, as the world economy changes, the institutions themselves must reform if they are to be effective. Ministers expressed satisfaction with recent reforms, including clarifying the limits placed on exceptional lending, collective action clauses, increasing reliance on grants in the World Bank, and the introduction of measurable results management to the institutions.

The Ministers agreed that there is a need to build on these reforms, and the 60th anniversary of the institutions is an appropriate time to do so. These are just the preliminary outcomes of our Strategic Review, which has already received a very positive response beyond the G-7 in emerging market and developing countries. The Review will continue after the Leaders meet, with full participation of the institutions and their shareholders. This is an important opportunity to identify new directions that will help ensure that the international financial institutions are equipped for modern markets and will be effective in promoting growth and stability well into the future.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 23, 2004
js-1683

Treasury Secretary John Snow chats with Mr. Joaquin Almunia,

All media queries should be directed to
The Press Office at (202) 622-2960.
Only call this number if you are a member of the media.

High Resolution Image

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 23, 2004
js-1685

Finance Ministers' Statement
May 23, 2004

We met to prepare for the Annual Economic Summit of our Leaders. The Summit is taking place at a time when the world economy is strong. The recovery is proceeding rapidly, with global growth of around 4-1/4 percent in 2003-04, the best growth rate in the world economy in the last fifteen years. Sound pro-growth policies in our countries have contributed to this recovery through such measures as tax reform, more flexible labor, product, and capital markets, reduced regulatory burdens, pension reforms, and strengthened financial sectors and macroeconomic policy frameworks.

There is now a strong foundation for our Leaders to enhance their cooperation and to advance the *Agenda for Growth* initiative to bolster job creation and productivity growth. We will work to implement labor market reforms, reduce regulatory and legal burdens, support entrepreneurship and innovation, and pursue healthcare reform. We reaffirm our commitment to sound public finances.

Yet risks to the outlook remain. Lower oil prices would benefit the world economy. We welcome the recent announcements by some oil producers to increase production. We now call on all oil producers to provide adequate supplies to ensure that world oil prices return to levels consistent with lasting global economic prosperity and stability, in particular for the poorest developing countries. Progress on trade liberalization is also critical to an improving world economy. We reaffirm our commitment to rapid progress on and early conclusion of the Doha Round.

Remittance flows at $100 billion per year support families and finance small businesses in developing countries, making them a key factor for growth and poverty reduction in these countries. We are engaged in overcoming institutional impediments to the transmission and receipt of remittances, improving financial education, increasing the range of services, and promoting partnerships to strengthen their development impact.

Entrepreneurship is essential for development. Financial and technical assistance are core elements of our efforts to support small business, and we have asked the MDBs to scale up these programs. We urge MDBs to work with bilateral donors and developing countries to develop and implement action plans to remove legal and regulatory obstacles to investment.

Economic reforms are underway in the broader Middle East and North Africa. We discussed ways to support the region's initiatives to improve the investment climate, support private sector growth, and provide effective technical assistance. A policy dialogue, focused on economic and financial issues based on regional ownership, is an effective mechanism to support reform in the region. We will meet again with regional Ministers this fall.

We discussed our Strategic Review of the World Bank and IMF and are gratified by the positive response we have received already. The goals of the Bretton Woods institutions are to promote economic and financial stability, raise economic growth, and fight poverty. We are pleased with recent reforms, including limits on exceptional access, enhanced surveillance, streamlined conditionality, collective action clauses, grants, and measurable results management. However, given the depth of change in the world economy, the institutions must reform further if they are to achieve their goals. At the time of their 60th anniversary, we believe that these reforms should be broadened on the basis of the principles of accountability and good governance, transparency, clarity of objectives and responsibility, and effective working with markets. We will continue to engage with the institutions and their shareholders on how they should best respond to these challenges.

We reaffirmed our strong commitment to debt sustainability in the poorest countries through debt relief and grants. We are committed to the full implementation of the HIPC initiative, including the provision of topping up relief where appropriate. We will bring forward proposals to address these issues.

- 30 -

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 24, 2004
js-1686

The Honorable John W. Snow Prepared Remarks Entrepreneurship Summit New York, NY

It's an honor to be here today with my colleague Chancellor Brown and some of the most innovative entrepreneurs in our world today to talk about something that is critical to our economies and our way of life: entrepreneurship.

In both the United States and Britain, we celebrate entrepreneurs for the unique role they play. In the U.S. we have found that the vast majority of our net new jobs are created in the small business sector, and that is enormously important, particularly in times like we've had recently, when we are in an economic recovery.

When President Bush designed his tax cut plans, he kept small business as a priority, and it has paid off. America's entrepreneurs benefited from the lowered burden of taxation and have responded with unprecedented growth and very strong job creation – 1.1 million jobs have been created over the past eight months.

In spite of its importance and our respect for it, we have no formal theory of entrepreneurship. Economists, who love to produce deterministic models, have been unable to model entrepreneurship.

The fundamental question about entrepreneurs remains unresolved: Is their central role to initiate change or do they respond to it? Probably both.

The basic question we face is how to increase the number of entrepreneurs, to spread the spirit of entrepreneurship; and how do we do it? That is what we need to understand better. That is why we have gathered here today.

Some things we know already: Entrepreneurs are essentially individualistic and self-reliant. They are people who trust their own judgment, so a culture that stresses individuality, independent judgment, self-reliance and self-confidence is certainly likely to be favorable to entrepreneurship. So is a culture that celebrates creativity and the joy of creativity.

We also know that entrepreneurship requires vision. It requires seeing what other people don't see, identifying opportunities and dreaming. I think the ability to dream and dream big lies at the heart of entrepreneurship. The lines of the famous poem apply – 'to strive, to seek and not to yield.' That is the spirit of entrepreneurship.

Entrepreneurs are the unique players in the drama of capitalism and we have no settled theory to explain them. Unlike most branches of economics, we have no mathematical models to predict or explain entrepreneurship. That is entirely understandable I suppose since economic models are essentially deterministic and innovation, entrepreneurship and creativity are decidedly random, uncertain and unforeseeable.

Schumpater talked about the entrepreneur as the 'prime mover' whose role was to innovate; the spark plug of change, the initiator of the new order of things, the rare souls who make a big difference in the way others -- most of the rest of us -- lead our lives.

The entrepreneur's innovations take many forms from new products and services to new technologies to new forms of organization to opening up new markets. What they all have in common is the game-changing nature of their activities.

When entrepreneurship is afoot, the world is in change; new products, new services, new technologies and new organizational forms are replacing the old. The replacement occurs because in some objective sense it is superior, it is better, it has won the war of ideas, the war of market acceptance and the war of market competition. In the process it creates wealth; wealth for the entrepreneur – the Henry Ford, the Andrew Carnegie, the Thomas Edison – as well as wealth for those who invest in the ventures they create and those who are employed by those ventures.

Other commentators on entrepreneurship, people like Professor Hayek and Professor Kirzner, view the entrepreneur's other essential role as exploiting information, information whose message they, and they alone, decipher. The information they exploit reveals opportunities for the better products, better services, better technologies, and better forms of organization.

Entrepreneurs come in all shapes and sizes and backgrounds. What they share is the ability to dream, to think big, to see opportunities and to make judgments against a backdrop of massive uncertainty. They are not managers, whose strength is analytical methods. Managers deal with risk. Risk can be measured, risk can be calculated, risk can be traded and priced through insurance markets.

But there are no analytical methods to resolve fundamental uncertainty. There are no rules to determine the outcome were uncertainty prevails. Uncertainty and the rarefied good judgment to deal with it is the province of the entrepreneur. The entrepreneur has no certain decision rules to look to, no maps, no calculus. There can be no map because the entrepreneur is going where no one else has gone before.

Like anything that exists naturally, we cannot re-create or mimic entrepreneurship. And we may not be able to ever fully understand it, much as we cherish it.

We do believe, however, that we can foster an environment that enables entrepreneurship to flourish. So I hope that our discussion today will shed more light on this phenomenon: the sources of entrepreneurship, the obstacles to entrepreneurship and what can be done to foster and encourage more of it.

###

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2004
JS-1687

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. Promotes Financial Education in Iowa by Recognizing Model Program and Visiting High School

Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. today presented a Certificate of Recognition to the John Lewis Community Services for its efforts in providing financial education to low-income and homeless individuals in Davenport, Iowa. John Lewis Community Services staff, volunteers, and clients also participated in the event.

"John Lewis Community Services does a great job of meeting its clients' short term needs, like food, shelter and employment, but also goes the extra step of helping with their long term needs through its financial education program," said Iannicola. "The program first rescues and then rehabilitates its clients by giving them a real hope of financial independence. The staff here uses financial education to help clients help themselves in a way that preserves their clients' dignity and self respect."

Founded in 1989, John Lewis Community Services provides hospitality and support to those in need and collaborates with the greater community to challenge the root causes of poverty by focusing on community development activities. Since April of 2003, over 100 individuals have received financial education through a variety of programs and services that John Lewis Community Services provides; and those in emergency shelter or individuals looking to purchase a first home, have received financial education services. The service currently uses the NCRC curriculum, which is modified to meet the individual needs of each participant.

While in Iowa, Iannicola also visited Jane Cox's class at Davenport Central High School. Family Credit Union representative Kris Lundquist used the *Game of Life* curriculum to teach the financial education lesson. Central High School is one of 269 high schools in Iowa using the *High School Financial Planning Program*, a National Endowment for Financial Education program. Through volunteers such as the Family Credit Union, the program provides teens with a greater understanding of, and ability to manage, their personal finances in the areas of goal setting, budgeting and saving.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, homeownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 20, 2004
js-1688

Treasury Deputy Secretary Samuel W. Bodman Opens Second Meeting of the Financial Literacy and Education Commission

Treasury Deputy Secretary Samuel W. Bodman today opened the second meeting of the Financial Literacy and Education Commission in the Department of the Treasury's Cash Room. Deputy Secretary Bodman welcomed the twenty representatives from federal departments, agencies and commissions that form the Commission, and thanked the participants for their continued commitment to improving financial education for all Americans. Government, nonprofit, and private sector guest speakers, including congressional representative Senator Daniel K. Akaka (D-Hawaii), also delivered remarks at the meeting and were thanked by the Deputy Secretary for their continued efforts in the area of financial education.

"I'm very pleased to see such widespread participation today and to be here to thank you for your continued commitment to improving financial literacy. There are many tangible examples of the progress we are making in this important endeavor," said Deputy Secretary Bodman. "The Commission is raising awareness and improving financial education in this country. In so doing, it is helping to improve the economic well-being and the quality of life of all Americans."

At today's meeting, the members of the Commission heard from the toll-free hotline and website subcommittees, established at the inaugural meeting last January, on their progress in developing and maintaining a toll-free hotline number for financial education purposes, as well as a financial education website to help the public seeking information about financial education resources and programs. Commissioner Sharon Brown-Hruska, Commodity Futures Trading Commission, delivered a presentation on the progress of the website subcommittee, and Deputy Director Donna J. Gambrell, Federal Deposit Insurance Corporation, presented on behalf of the hotline subcommittee.

Other guest speakers discussed financial education best practices in their organizations. Governor Edward M. Gramlich, Board of Governors of the Federal Reserve System, discussed the Federal Reserve Board's increased efforts to educate employees about personal financial management through programs like *There's a Lot to Learn About Money!* North Dakota Commissioner Karen Tyler, North American Securities Administration Association, highlighted the association's financial education initiatives in general and outreach to students and seniors through its *Senior Investor Outreach Initiative* and *Youth Outreach: Teacher Training Blueprint* program. Executive Director Laura Levine, Jump$tart Coalition for Personal Financial Literacy, discussed the organization's national financial education efforts and the results of a recently released nationwide survey that reveals increased aptitude in managing financial resources among high school students. President Carrie Schwab Pomerantz, Charles Schwab Foundation, also delivered a presentation on its *Money Matters: Make It Count* program, created to promote financial literacy among teens by building basic money management skills.

The Financial Literacy and Education Commission was created by Title V of the Fair and Accurate Credit Transactions Act, signed by President Bush on December 4, 2003 . The Commission is composed of the Secretary of the Treasury and the heads of the Office of the Comptroller of the Currency; the Office of Thrift Supervision; the Federal Reserve; the Federal Deposit Insurance Corporation; the National Credit Union Administration; the Securities and Exchange Commission;

the Departments of Education, Agriculture, Defense, Health and Human Services, Housing and Urban Development, Labor, and Veterans Affairs; the Federal Trade Commission; the General Services Administration; the Small Business Administration; the Social Security Administration; the Commodity Futures Trading Commission; and the Office of Personnel Management.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 24, 2004
js-1689

IMF Concludes Article IV Consultation with the United States

The Treasury Department is releasing today the concluding statement by the staff of the International Monetary Fund (IMF) following this year's Article IV consultation with the United States. This statement represents IMF staff's independent judgment and assessment of U.S. economic performance and policies.

Release of this statement is consistent with the United States' longstanding, strong support for enhanced transparency of the IMF The United States also plans to release the IMF staff report and Public Information Notice on the U.S. Article IV review following the Executive Board's discussion of the mission later this summer.

REPORTS

- International Monetary Fund – 2004 Concluding Statement of the Fund Mission

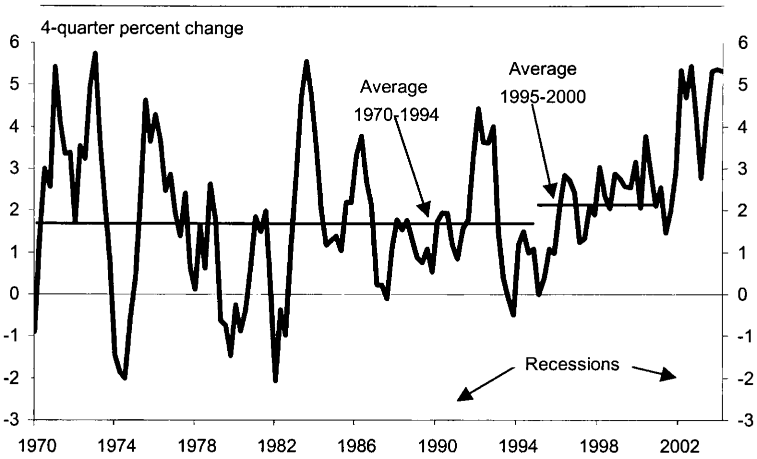
INTERNATIONAL MONETARY FUND

2004 Article IV Consultation with the United States of America

Concluding Statement of the Fund Mission
(May 21, 2004)

1. **The U.S. recovery has gathered considerable momentum since last year, again leading the global recovery.** The economy has weathered an unprecedented series of adverse shocks—including the collapse of the IT-bubble, terrorist attacks, geopolitical uncertainties, and weaknesses in corporate governance—and has been expanding strongly since mid-2003. Encouragingly, the upturn reflects continuing exceptional U.S. productivity growth, in addition to the sizable injection of monetary and fiscal stimulus.

Productivity growth has remained strong.



2. **Most indicators point to a robust expansion in 2004 and give confidence that the United States will continue to act as the key engine for global growth, especially in the context of relative weakness of demand abroad.** Support from household and government spending is projected to ease in the coming year as the effects of policy stimulus wane. However, corporate sector profitability and cash flow have rebounded strongly, business investment is picking up, and net exports are expected to benefit from the dollar's recent depreciation. Some downside risks remain, including from the geopolitical situation and its implications for energy prices. Moreover, there remains the possibility of a more abrupt slowdown of household demand given the low household saving rate, relatively sluggish employment growth, and concerns regarding overvaluation in some real estate markets and large consumer debt loads. However, these risks appear balanced by the possibility of further upside surprises to the economy's supply side.

3. **With the improved near-term outlook, the coming year provides an important opportunity for withdrawing policy stimulus and putting in place the conditions needed for a durable and sustained expansion:**

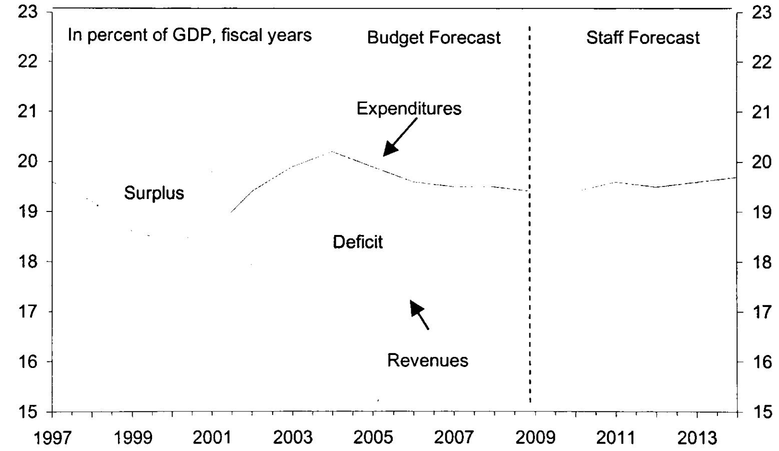
- ***Fiscal sustainability***. The key challenge is to entrench a lasting framework for restoring fiscal surpluses and paying down federal debt ahead of the retirement of the baby-boom generation while moving rapidly on entitlement reform. Such an objective would anchor an improvement in national saving and avoid U.S. fiscal deficits crowding out investment at home and abroad.

- ***An orderly withdrawal of monetary stimulus.*** The ongoing recovery creates room to begin adjusting interest rates to more neutral levels, and the Federal Reserve has already prepared the ground for the withdrawal of stimulus.
- ***Leadership on trade and financial sector policies.*** With multilateral trade talks at a critical juncture, and weaknesses in corporate governance continuing to be a concern domestically and abroad, the United States has an important opportunity to continue its leadership role in these areas.

Fiscal policy

4. **The FY2005 budget has signaled a welcome shift toward fiscal consolidation in the coming two years.** Although the recent stimulus has provided valuable support to the economy, with the recovery now well on track, the deficit reduction assumed for FY2005 and FY2006—roughly 2 percentage points of GDP—is appropriate. Encouragingly, there are also signs that the FY2004 deficit could be smaller than originally estimated. However, fiscal prospects in the next two years remain subject to important uncertainties—including with regard to ongoing operations in Iraq and Afghanistan and the budgetary cost of a number of legislative initiatives presently before Congress. The challenge will be to contain such pressures and to ensure that the better-than-expected results this year are used to strengthen subsequent deficit-reduction objectives.

The FY2005 Budget projects significant consolidation through FY2006 and a more gradual path subsequently.

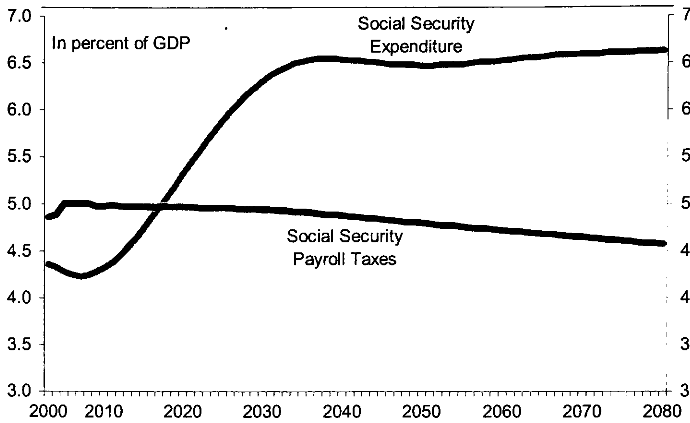


5. **A similarly ambitious rate of deficit reduction beyond the next two years would help place the long-run fiscal position on a more sustainable basis.** Recent budget documents have highlighted that federal deficits and debt will start to rise over time as the baby-boom generation begins to retire and place increased demands on entitlements. Indeed, the long-term fiscal imbalance has widened in recent years as a result of tax cuts and the expansion of Medicare benefits. Therefore, the deficit reduction that is currently envisaged after FY2006 appears modest and may also be challenging, since it assumes success in lowering nondefense discretionary spending as a share of GDP to its lowest level since the 1960s and a sharp increase in taxpayer liabilities under the Alternative Minimum Tax.

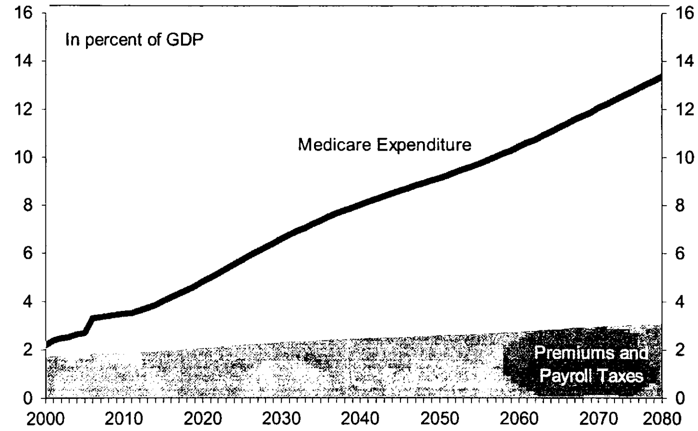
6. **Against this background, we continue to recommend aiming for a balanced budget, excluding Social Security, say by the end of the decade.** While entitlement reform holds the key to long-run fiscal sustainability, based on past experience it can take a long time to design and phase in measures that would place such programs on a sound financial footing. Restoring a fiscal surplus equal to the cash-flow surplus of the Social Security system by the end of the decade would allow U.S. federal debt to be paid down ahead of the retirement of the baby-boom generation, and provide greater fiscal room to build consensus around and implement entitlement reforms. Moreover, staff analysis suggests that reducing the budget deficit by 1 percentage point of GDP annually through the rest of this decade—roughly the rate envisioned for FY2005–06—could provide significant supply-side benefits to the United States and elsewhere by reducing pressures on global interest rates and investment, with only modest effects on short-term activity.

7. **The recovery provides a valuable opportunity for embarking upon the fiscal effort that is needed to achieve such a medium-term objective**. The Administration has supported re-authorizing a

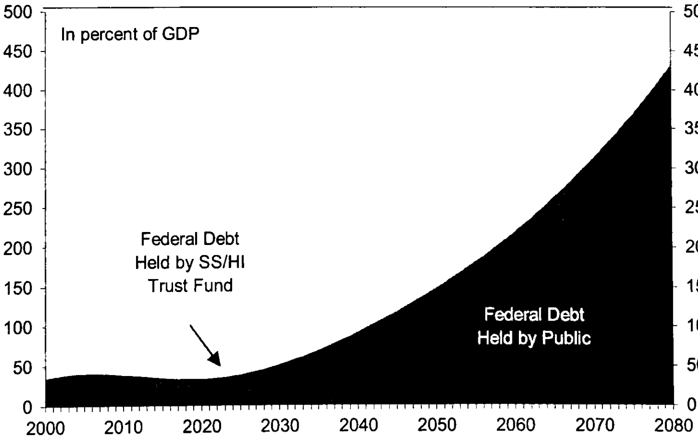
Underfunding of Social Security could be dealt with by reforms such as indexing accrued benefits to prices rather than wages...



... while the unfunded liabilities of Medicare are larger and driven by cost increases as much as demographic pressures.



In the absence of reforms, Federal debt is projected to rise steadily as a ratio to GDP.



strengthened version of the Budget Enforcement Act (BEA), which could provide the necessary framework for solidifying fiscal responsibility and expenditure discipline. However, the proposal to exclude most revenue measures from the coverage of the pay-as-you-go requirement and to shorten its horizon to five years would weaken the legislation's discipline. As for the measures needed to achieve consolidation, curtailing expenditures will undoubtedly be an essential element, especially given the rapid growth of outlays in recent years, and curbing business and agricultural subsidies could help boost the economy's supply side. Nonetheless, given the magnitude of the fiscal adjustment required and already ambitious plans for cutting nondefense discretionary spending, revenue enhancements should not be ruled out. To avoid having to unwind recent marginal tax rate cuts and give up their potential supply-side benefits, emphasis should be laid on reforms to broaden and simplify the tax base, such as by cutting tax expenditures, which are significant and distort resource allocation.

8. **Delaying measures to address the Social Security system's funding problems will entail larger and more painful adjustments later on.** The Administration has already taken the important step of commissioning reform proposals, and the 2004 *Economic Report of the President* illustrates that amending indexation formulas would slow benefit growth and eliminate the system's underfunding. It also shows that diverting a portion of the payroll tax into private retirement accounts would have the effect of significantly boosting the federal budget deficit and the debt/GDP ratio over the next 45 years, illustrating the importance of coupling this measure with durable steps to address long-term fiscal sustainability. These concerns aside, the key priority remains to translate this analysis into concrete reform proposals.

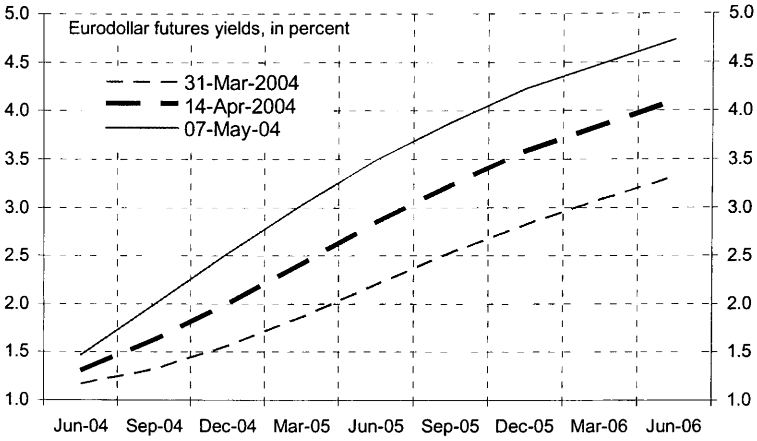
9. **The financial problems of the Medicare system dwarf those of Social Security, and have increased as a result of the additional drug benefits introduced last year.** The Medicare Reform legislation included useful initiatives to introduce competition and increase efficiency in health care delivery, and the means-testing of Part B premiums could enable enhancements of system revenues. However, the Medicare system is still expected to begin running cash-flow deficits by the end of the next decade and outlays are projected to triple as a share of GDP by mid-century. Although demographic pressures are a significant factor behind this deterioration, cost increases associated with technological advances are equally important. This suggests that durable solutions to the Medicare problem may also require broader, efficiency-enhancing reforms of the U.S. health care system.

Monetary policy and the exchange rate

10. **The Federal Open Market Committee (FOMC) has appropriately begun preparing markets for the gradual withdrawal of stimulus.** The aggressive easing of recent years has provided essential support to the recovery, and the Federal Reserve is to be commended for forestalling fears of deflation that emerged last year. However, the recent signs that the recovery is maturing, labor market conditions are improving, and concerns that higher energy prices could revive inflation expectations, suggest that the time has come to start removing stimulus. Against this background, the FOMC's May 4 statement

appropriately signaled a shift in policy bias, while recognizing the scope for a measured withdrawal of stimulus. In light of the usual transmission lags for monetary policy and the fact that the current federal funds rate is well below levels consistent with a neutral stance, it is encouraging that the FOMC's statement has helped market participants recognize the need for an earlier withdrawal of monetary stimulus.

Market expectations for the future path of short-term interest rates have shifted upward in response to incoming data and policy statements.



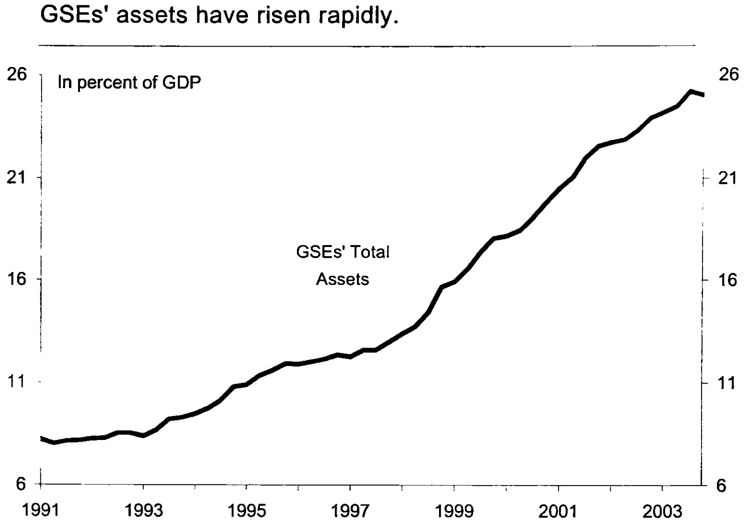
11. **By any standards, the Federal Reserve is highly transparent.** It remains an open issue, however, whether still further information on the Federal Reserve's analysis and intentions would improve the effectiveness of monetary policy. We welcome, therefore, the FOMC's January 2004 discussion of the possible benefits of more systematic statements of the balance of risks and policy intentions, of accelerating the publication of FOMC minutes, and of providing greater detail of the FOMC's macroeconomic forecasts. From a broader perspective, the Federal Reserve could further anchor expectations by clarifying its definition of price stability and its medium-term inflation objective.

12. **Financial markets have demonstrated during the past year their ability to digest significant exchange rate movements.** Nonetheless, the U.S. current account deficit is still expected to remain large at 5 percent of GDP, dependent upon foreign private and official investor appetite for net claims against U.S. residents, with the attendant risk that shifts in such demand could result in more abrupt adjustments of interest and exchange rates. To be sure, a smooth resolution of global current account imbalances must involve stronger growth abroad. However, determined efforts to strengthen the U.S. fiscal position would raise national saving and help ensure that the inevitable adjustment is orderly and does not place an undue burden on investment, both domestically and abroad.

Financial sector and corporate governance

13. **The banking sector has proven its resilience over recent years and ongoing reforms of corporate governance have increased confidence in market integrity.** Indeed, high levels of bank capital, improvements in credit quality, and strong risk management appear to have left the financial system well prepared for the expected withdrawal of monetary stimulus. The authorities have also moved effectively to implement the Sarbanes-Oxley legislation to strengthen corporate governance, including registration of the accounting profession through the new Public Company Accounting Oversight Board. Looking ahead, it will be important to ensure that the Financial Standards Accounting Board is able to fulfill its

responsibilities in an independent manner, while recent revelations with respect to the mutual fund industry also suggest the need for continued vigilance with regard to financial market practices.



14. **The Administration has raised justifiable concerns regarding the large and increasing share of mortgage-backed securities held by the main government sponsored enterprises (GSEs).** The growth of these institutions has concentrated interest rate and mortgage prepayment risk, and the Administration's proposal to overhaul the current supervisory regime and establish an independent regulator with powers to set capital requirements and put a GSE into receivership, if needed, warrants legislative support.

Trade policy and overseas development assistance

15. **The U.S. authorities have taken welcome steps to provide impetus to the Doha Round negotiations following the breakdown in talks in Cancun.** Continued U.S. leadership and commitment to multilateral approaches to trade liberalization, especially with regard to agriculture, will be critical to the success of the Round. In this regard, legislative action to abide by WTO rulings, including with regard to the Foreign Sales Corporation export subsidy, would help demonstrate the continued U.S. commitment to the WTO. The mission also urges U.S. policymakers to extend the third-country fabric provision of the African Growth and Opportunity Act, which expires shortly, in order to avoid an unwelcome disruption to the trade of participating countries.

16. **Recent increases in U.S. official development assistance (ODA) and progress on Millennium Challenge Account are welcome**. However, U.S. ODA remains the lowest among industrial countries as a share of GDP and the mission urges continued efforts to boost U.S. foreign assistance.

RESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 24, 2004
2004-5-24-17-32-50-816

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 $82,064 million as of the end of that week, compared to $81,037 million as of the end of the prior week.

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

		May 14, 2004			May 21, 2004	
TOTAL		**81,037**			**82,064**	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	9,411	13,762	23,173	9,535	14,033	23,568
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,676	2,765	14,441	11,813	2,820	14,633
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			20,081			20,354
3. Special Drawing Rights (SDRs) [2]			12,297			12,464
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

		May 14, 2004			May 21, 2004	
	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

	May 14, 2004			May 21, 2004		
	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 IMF data for the prior month end.

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 26, 2004
JS-1690

Treasury Announces Release Of Report On "Phishing" At Identity Theft Forum In Kansas City

FBIIC and FSSCC Publish Report on Preventing, Detecting, and Responding to Phishing Attacks

Assistant Secretary of the Treasury, Wayne A. Abernathy, today announced the release of a new report on the rapidly growing cyber-crime known as "phishing," at a forum on identity theft in Kansas City, Missouri.

"When President Bush signed legislation giving consumers and law enforcement important new tools to fight the spread of identity theft, he sent a message to identity thieves that their schemes would not be tolerated. The report being issued today by the FBIIC and FSSCC gives consumers even more information on how to detect, prevent, and mitigate the effects of the identity theft scheme known as phishing, a crime that costs American consumers and businesses billions of dollars every year," said Assistant Secretary Abernathy.

The Finance and Banking Information Infrastructure Committee (FBIIC) and the Financial Services Sector Coordinating Council (FSSCC) jointly prepared the report, "Lessons Learned by Consumers, Financial Sector Firms, and Government Agencies during the Recent Rise of Phishing Attacks."

The FBIIC, an organization comprised of representatives from federal and state financial regulators, coordinates and communicates among financial regulators to enhance the resiliency of the financial system. The FSSCC, an organization comprised of representatives from financial services organizations and trade associations, fosters and coordinates sector-wide voluntary activities and initiatives designed to improve critical financial infrastructure and homeland security. The FBIIC and the FSSCC work closely with the U.S. Department of Treasury to combat financial crime, to strengthen the critical financial infrastructure of the U.S., and to mitigate the effect of manmade and natural disruptions on the financial system.

In "phishing" schemes, an email is sent to a consumer, directing him or her to a fraudulent website. In many cases, the crook has designed the fraudulent website to closely resemble that of a legitimate organization – one that may have wide name recognition or that typically inspires trust among consumers. The spoofed website typically asks consumers to update sensitive personal and financial information that is then used by identity thieves to commit fraud. Recent phishing emails have purportedly come from government agencies, legitimate financial sector firms, Internet auction sites, and electronic payment services.

A recent private sector report found that 1,125 instances of "phishing" were reported in April 2004, alone – an increase of 180% from March 2004 to April 2004. The report finds that financial services industry websites are the most commonly spoofed.

The FBIIC/FSSCC report was released as part of a forum on identity theft entitled "Fighting Identity Theft: Outsmarting the Crooks" held at Penn Valley Community College in Kansas City, Missouri. The U.S. Department of the Treasury and BITS, a financial services industry consortium that addresses electronic banking problems, co-hosted the forum. The forum featured risk management experts from the financial services industry, law enforcement officials operating at the federal, state, and local levels, and representatives from technology companies developing new ways to stop identity thieves. During today's program, the forum participants offered consumers helpful advice on how to outsmart the crooks.

In addition, through the leadership of the President in signing the FACT Act last year, consumers have been given greater power to fight identity theft and other financial frauds."

In addition to Assistant Secretary Abernathy, other participants included Ms. Catherine A. Allen, CEO, BITS and Mr. Camden Fine, President and CEO, Independent Community Bankers of America.

Ten million Americans a year fall victim to Identity Theft, the fastest growing white collar crime in the country. Operating across state and national borders, identity thieves cost U.S. business and finance at least $50 billion a year in fraudulent transactions.

Visit www.treas.gov/offices/domestic-finance/financial-institution/cip/ to view the FBIIC/FSSCC report.

-30-

REPORTS

- FBIIC and FSSCC Report on Preventing, Detecting, and Responding to Phishing Attacks (PDF)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

September 29, 2004
JS-1991

Iannicola Teaches Credit Management Class to Carson City High School Students in Nevada

Treasury's Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr., today taught a credit management class and personal finance skills to high school students at the Greater Nevada Credit Union's Carson High School Educational Branch. Iannicola discussed federal financial education resources available for use by credit unions in their financial education programs. Iannicola visited with the students employed at the credit union branch at the high school and answered questions for them.

Iannicola told the students about how managing credit wisely can help them establish a good credit history. He also emphasized how doing so can help them achieve important life goals like obtaining a higher education, getting a job and becoming owners of their own homes. "The Greater Credit Union Education Branch is a great use of experiential learning to help raise students' financial awareness," said Iannicola. "Both the student workers and the student members are learning how to responsibly manage a relationship with a financial institution. This is a skill that will benefit them their entire lives."

Iannicola thanked the Greater Nevada Credit Union for their efforts to help improve the financial literacy of students in Carson City, specifically through the branch located inside Carson High School. The 250 square foot Carson High School Educational Branch opened in 1996 and is designed to give students an opportunity to receive "real world" job experience and learn about managing money.

Established in 1949, Greater Nevada Credit Union is a not-for-profit financial institution that is owned by its membership and offers a full range of consumer banking services. The Greater Nevada Credit Union also provides financial literacy support by teaching classes, as requested by schools and other organizations, using materials from The National Endowment for Financial Education.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 25, 2004
JS-1692

The U.S. -- African Mortgage Market Initiative
By John B. Taylor
Under Secretary for International Affairs
United States Treasury
Remarks for the African Development Bank Round Table on the Role of Mortgage Finance in Developing Capital Markets
Kampala, Uganda
May 25, 2004

The development of mortgage markets is important for the overall development of a country. It contributes to employment, the development of commercial banking and ultimately to the development of capital markets. Most importantly, it increases the well-being of households by providing superior shelter and helping establish personal wealth - wealth that can be leveraged for creation of more wealth.

Yesterday my colleagues made the point that housing is a significant component of the economy of the United States. I think that this point should be emphasized. Housing and its related industries contribute roughly 20% to the U.S. GDP This number is large because housing affects not only home building but it also stimulates other varied parts of the economy such as banking, professional services, building materials and even the production of furniture and appliances. The mortgage finance industry alone generates $7 trillion in new mortgage originations a year and contributes to a robust market in mortgage-backed securities and other capital markets products.

The mortgage market in the U.S. was not always so successful. In fact, 70 years ago it was virtually non-existent. If someone wanted to buy a home, the options were very limited. A person could either pay cash or, if he was very lucky and had a good relationship with a local banker, could obtain a short-term loan – usually less than 10 years in duration.

This situation changed almost overnight when in 1934 the U.S. Congress created the Federal Housing Administration, also called the FHA. FHA mortgage insurance made 30 year mortgage loans possible by providing comfort to commercial lenders to lend long term. Essentially the government assumed the credit risk of mortgage lending thus creating a new market for commercial banks.

After the creation of the FHA, the U.S. mortgage market began to grow. It was not, however, until after the second World War that the mortgage market's growth surged. Soldiers returning from the war were in need of housing. To help the private sector meet the increased demand, Congress again enacted legislation now commonly know as the GI Bill. Among the provisions of the legislation was a new mortgage insurance program and down payment assistance for veterans. The result of the GI Bill was to make homeownership accessible to even more Americans. The GI Bill directly helped me and my family. My father was one of those veterans returning from the war who was able to purchase a home through the GI Bill. Using the Veteran's guarantee he bought our first home in Levittown, New York.

Acknowledging the critical contribution of housing finance to the development of economic well being, President Bush announced last summer in Abuja, Nigeria his desire to see mortgage markets developed in Africa. He requested that the Treasury Department lead a US government effort to assist African nations develop their respective mortgage markets. We are using institutions such as the Overseas Private Investment Corporation (also known as OPIC) as well as USAID and its Development Credit Authority to create mortgage and micro finance programs. In addition, with assistance from Ginnie Mae, my organization is developing technical assistance programs focused on both primary and secondary market development in a number of African countries.

Before I go on, it is important to point out that before we can expect development of a mortgage market, some prerequisites need to be in place. These include, (1) defined property rights and the ability to transfer title of real estate; (2) a legal system that supports the enforcement of contracts as well as support the ability of lenders to foreclose on defaulted loans and efficiently seize and resell collateral; and (3) stable macroeconomic environment that is favorable to long term mortgage lending. The primary focus of our work, however, is not these prerequisites but rather the development of lending programs as well as the institutions that are required for lending. Such institutions include liquidity facilities and credit risk management programs.

The success of the FHA in part guides our work in Africa. We have taken the position that effective management of credit risk is critical for the introduction of long-term lending and requires a threefold approach of loan underwriting, loan servicing and mortgage insurance aimed at the unique needs of low-income and informal sector households.

Since President Bush's announcement, the U.S. has been very active in developing mortgage programs in a number of African countries. We have commitments for funding almost $50 million in mortgage market related programs though OPIC loans and USAID grants. In addition, my department is working on policy and institutional design of credit risk management facilities and a secondary market transaction. Some of our projects include:

- $8 million OPIC loan for the construction of 500 single family homes in Uganda. The program is particularly interesting because once the construction loan is repaid, the funds will be re-loaned to a local financial institution which will on-lend the funds to households for 15 year mortgage loans.

- $5 million OPIC loan for the guarantee of local bank financing for the construction of 500 low income apartments in South Africa.

- $4 million USAID grant for the establishment of a micro lending facility for housing and small business development in Nigeria. An innovative feature of this project is that the facility will rely primarily on local private sector financial institutions for liquidity.

- $3.5 million OPIC loan for the construction of 175 middle income homes in Nigeria. We are looking into the possibility of adding a mortgage component to this program.

- $5.3 million in OPIC loans for the construction of 300 middle income housing units in Ghana. While this is currently a construction program, we are looking into the possibility of extending it into a mortgage lending program.

- $5 million OPIC loan for the construction of 750 low income homes. The program also includes a lease-purchase program which will act similarly to a mortgage lending program.

My staff is currently working with the government of Botswana helping them to develop a mortgage-backed securities program to provide liquidity to local banks.

These programs and others that the United States is undertaking are a start in developing mortgage markets in Africa. I am encouraged that the African Development Bank has also taken an interest in the topic and hope that it will be able to fund similar programs. To this end, I propose that the Bank adopt firm goals for the development of mortgage markets. Success can be measured by the ratio of mortgage debt outstanding to GDP.

For many African countries the time is right to seriously address the issue of mortgage finance. I look forward to collaborating with the Bank on this important issue.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

May 27, 2004
JS-1693

Treasury Issues Guidance on Creative Properties in the Film Production Industry

The Treasury Department and IRS issued guidance today to clarify when film producers may recover costs incurred in acquiring or developing screenplays, scripts, and other creative properties that are not scheduled for production.

“For many years, the industry accounted for these costs in the same way for both tax and financial reporting purposes,” stated Acting Assistant Secretary for Tax Policy Gregory Jenner. “After a change in the applicable financial reporting rules, the industry asked us to address the tax treatment of these costs as part of the Industry Issue Resolution (IIR) program.”

The revenue ruling issued today holds that a film producer may not claim an abandonment loss for the capitalized costs of acquiring or developing creative properties unless the producer establishes an intention to abandon the property and an affirmative act of abandonment occurs. The revenue ruling also holds that a film producer may not claim a deduction for worthlessness unless identifiable events evidencing a closed and completed transaction establishing worthlessness occur.

The revenue procedure issued today provides a safe harbor method of accounting that permits taxpayers to amortize over a fifteen-year period costs for creative properties that are not scheduled for production within three years of acquisition.

REPORTS

- Rev. Rul. 2004-58
- Rev. Proc. 2004-36

Part I

Section 165.--Losses

26 CFR 1.165-1: Losses.
(Also § 1.165-2)

Rev. Rul. 2004-58

ISSUE

May a taxpayer deduct the cost of acquiring and developing creative property as a loss under § 165(a) of the Internal Revenue Code in the situations described below?

FACTS

X is a corporation that files returns on a calendar year basis for federal income tax purposes. *X* is engaged in the trade or business of producing motion pictures. As part of that trade or business, *X* routinely incurs costs to acquire and develop creative property such as screenplays, scripts, treatments, story outlines, motion picture production rights to books, plays, and other literary works, and similar property for purposes of potential development, production, and exploitation. The type of rights *X* acquires in creative property varies from property to property and may include exclusive rights of ownership or limited exploitation rights, and may include rights for the entire remaining copyright term of the property or rights for a limited period of time.

X ultimately sets for production only a small percentage of the creative property that *X* acquires. Most of the creative property that *X* sets for production is set within three years of *X*'s acquisition of the property. However, *X* does set some property for production that *X* has held for longer than three years. Additionally, *X* may sell to a third party *X*'s rights to a creative property not set for production. *X* does not discard, release to the public domain, or otherwise dispose of the creative properties not set for production or sold. Generally these properties are retained indefinitely.

In order to preserve the properties in a condition that allows for future use, *X* maintains facilities for storing creative property retained but not set for production. *X* retains these properties for various reasons, including, but not limited to, the following:

1. To exercise *X*'s ownership or other contractual rights at any time in the future by, among other things,
    a. selling or setting a property for production if, for example, the subject matter becomes more popular or the writer becomes well known;
    b. preventing or defending against a possible future copyright infringement lawsuit; and
    c. keeping competitors from developing the property; and

2. To maintain good relations with the seller of the property.

For financial accounting purposes, *X* applies generally accepted accounting principles (GAAP) to the cost of acquiring and developing creative property. For creative property that has not been set for production, *X* recognizes a loss for financial accounting purposes in the earliest of: (1) the year in which *X* decides not to set the property for production; (2) the year in which *X* sells or otherwise disposes of the property; or (3) the third year following the year in which *X* acquires the property.

Situation 1

In 2003, *X* purchases the exclusive rights for the remainder of the copyright term to script *a*. In 2004, an *X* executive decides that *X* will not set script *a* for production. In accordance with *X*'s financial accounting practice, in 2004 *X* writes off for financial accounting purposes the cost of acquiring and developing script *a*. Although *X* writes off the cost of script *a* for financial accounting purposes and does not set script *a* for production, *X* retains all rights to script *a* indefinitely.

Situation 2

In 2003, *X* purchases limited exploitation rights to use screenplay *b* in the production of a motion picture. Under the terms of the purchase agreement, all of *X*'s rights in screenplay *b* expire if screenplay *b* is not set for production within four years from the date of the agreement. *X* executives do not make a specific decision not to set screenplay *b* for production, but screenplay *b* is not set for production by the time *X*'s rights in screenplay *b* expire in 2007. In accordance with *X*'s financial accounting practice, in 2006 *X* writes off for financial accounting purposes the cost of acquiring and developing screenplay *b*. Although *X* writes off the cost of screenplay *b* for financial accounting purposes and does not set screenplay *b* for production, *X* continues to retain exploitation rights to screenplay *b* until 2007, at which time those rights expire. *X* does not attempt to renew, extend, or otherwise reacquire any rights to screenplay *b*.

Situation 3

In 2003, *X* purchases motion picture rights *c*, the exclusive rights to produce motion pictures based on a particular novel, from *A*, the author of the novel. Under the terms of the contract, *A* has an option to reacquire motion picture rights *c* if *X* does not set them for production within two years of acquisition. In 2005, *X* decides not to set motion picture rights *c* for production in the foreseeable future. *X* informs *A* that *A* has the right to reacquire the rights pursuant to the option. *A* contacts other studios to determine if they are interested in acquiring motion picture rights *c*, but is unable to find another studio to purchase the rights for a satisfactory price. Therefore, *A* declines to exercise the option. In accordance with *X*'s financial accounting practice, in 2005 *X* writes off for financial accounting purposes the cost of acquiring and developing motion picture rights *c*. *X* retains motion picture rights *c* indefinitely.

LAW AND ANALYSIS

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(b) states that the amount of the deduction for a loss is the adjusted basis as provided in § 1011. *See also* § 1.165-1(c) of the Income Tax Regulations.

Section 1.165-1(b) provides that, to be allowable as a deduction under § 165(a), a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event, and, except as provided in § 165(h) and § 1.165-11, actually sustained during the taxable year. Section 1.165-1(d)(1) provides that a loss is treated as sustained during the taxable year in which the loss occurs, as evidenced by a closed and completed transaction, and as fixed by an identifiable event occurring in such taxable year.

Section 1.165-2(a) allows a deduction under § 165(a) for a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, when such business or transaction is discontinued or when such property is permanently discarded from use therein. Section 1.165-2(a) further provides that the taxable year in which a loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

Section 165 losses have been referred to as abandonment losses to reflect that some act is required that evidences a taxpayer's intent to permanently discard or discontinue use. *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396, 402 (3d Cir. 1990). To establish the abandonment of an asset for purposes of § 165, a taxpayer must show both (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *CRST, Inc. v. Commissioner*, 92 T.C. 1249, 1257 (1989), *aff'd*, 909 F.2d 1146 (8th Cir. 1990); Rev. Rul. 93-80, 1993-2 C.B. 239. A deduction is not allowable if a taxpayer intends to hold and preserve property for possible future use or to realize potential future value from the property. *A.J. Indus.*, 503 F.2d at 670. Abandonment of an intangible property interest should be accompanied by some express manifestation. *Citron v. Commissioner*, 97 T.C. 200, 209 (1991). *See also Echols v. Commissioner*, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their 75% partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

The "identifiable event" required by § 1.165-1(b) and (d)(1) "must be observable to outsiders and constitute 'some step which irrevocably cuts ties to the asset.'" *United Dairy Farmers, Inc. v. U.S.*, 267 F.3d 510, 522 (6th Cir. 2001) (quoting *Corra Resources, Ltd. v. Commissioner*, 945 F.2d 224, 226 (7th Cir. 1991)). Mere non-use of an asset is not sufficient to establish an act of abandonment. *Standley v. Commissioner*, 99 T.C. 259, 272 (1992), *aff'd without published opinion*, 24 F.3d 249 (9th Cir. 1994); *Jones Beach Theatre Corp. v. Commissioner*, T.C.M. 1966-100. Similarly, internal communications or decisions within a taxpayer's organization are not sufficient affirmative acts of abandonment. *See Corra Resources*, 945 F.2d at 226.

A taxpayer need not relinquish legal title to property in all cases to establish abandonment, provided there is an intent to abandon and an affirmative act of abandonment. *See Echols*, 935 F.2d at 706; *Middleton v. Commissioner*, 77 T.C. 310, 322 (1981), *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982). Retention of bare legal title to property does not preclude a deduction under § 165(a) in certain cases in which property has become worthless. *See Helvering v. Gordon*, 134 F.2d 685, 689 (4th Cir. 1943), *acq.*, 1951-1 C.B. 2; *Rhodes v. Commissioner*, 100 F.2d 966, 970 (6th Cir. 1939); Rev. Rul. 54-581, 1954-2 C.B. 112. In such cases the courts have adopted the rule that a taxpayer may claim a loss on property without being required to divest legal title if the taxpayer does not intend to hold the property and the taxpayer proves by identifiable events that the property has become worthless. *A.J. Indus.*, 503 F.2d at 670. The taxpayer's conduct in regarding the property as worthless and not intending to preserve or hold it may be the practical equivalent of abandonment. *See id.*; *Lockwood v. Commissioner*, 94 TC 252, 258 (1990) (leaving master recordings on a closet shelf instead of storing in a necessary climate-controlled environment was tantamount to throwing them in the trash).

A deduction for worthlessness under § 165 is allowable only if there is a closed and completed transaction fixed by identifiable events establishing that the property is worthless in the taxable year for which the deduction is claimed. § 1.165-1(b) and (d)(1). Although the taxpayer is not required to be an "incorrigible optimist," *United States v. S.S. White Dental Manufacturing Co.,* 274 U.S. 398, 403 (1927), a mere diminution in the value of an asset is not sufficient to establish worthlessness. *Proesel v. Commissioner*, 77 T.C. 992, 1006 (1981). Assets may not be considered worthless, even when they have no liquidated value, if there is a reasonable hope and expectation that they will become valuable in the future. *See Lawson v. Commissioner*, 42 B.T.A. 1103, 1108 (1940); *Morton v. Commissioner*, 38 B.T.A. 1270, 1278 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940); Rev. Rul. 77-17, 1977-1 C.B. 44.

Abandonment and other transactions that divest the taxpayer's title are identifiable events that support a closed and completed transaction. Additionally, identifiable events may include "other acts or events which reflect the fact that the property is worthless." *Proesel*, 77 T.C. at 1005. To the extent that the transactions do not include divestitures of title or abandonment, the essential element for tax purposes is that a particular event destroyed the potential value and usefulness of the asset to the taxpayer. *See Echols*, 950 F.2d at 213 (partnership's insolvency, third party developer's default, and inability of partners to restructure the underlying debt were identifiable events that evidenced worthlessness); *Corra Resources,* 945 F.2d at 226-27 (loss realized in the year in which coal mining lease expired); *George Freitas Dairy, Inc. v. United States*, 582 F.2d 500, 502 (9th Cir. 1978) (cancellation of production quota contract was identifiable event that evidenced the closed and completed transaction); *Proesel*, 77 T.C. at 998-99, 1006-07 (finding insufficient evidence of worthlessness despite unsuccessful attempts to sell or find distributor for a motion picture by contacting all major studios and major independent distributors; however, contract to produce the motion picture could have been found worthless upon settled litigation with respect to breach of contract or demonstration that litigation would be fruitless); *Oak Harbor Freight Lines, Inc. v. Commissioner*, T.C.M. 1999-291 (an act of Congress rendered motor carrier authorities worthless because all rights associated with the authorities were eliminated); *Springfield Productions, Inc. v. Commissioner,* T.C.M. 1979-23 (testimony by taxpayer's president that film was worthless because taxpayer had unsuccessfully submitted it for sale or distribution to all major studios and small distribution companies was not substantial proof of worthlessness); *Golden State Towel and Linen Service, Ltd. v. United States*, 179 Ct. Cl. 300, 310 (1967) (finding that it is only when all or a substantial, identifiable, vendible portion of a customer list is terminated permanently, either through extraneous causes or the sudden and involuntary inability of the owner to serve them, that a tax loss may be claimed, and then only if the loss may be adequately measured.)

A taxpayer's treatment of the costs of acquiring property for financial accounting purposes does not control the treatment of those costs for federal income tax purposes. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-44 (1979).

X has not performed an affirmative act of abandoning creative property merely because: (1) an *X* executive decides not to actively pursue the development or production of the property, *see Corra Resources*, 945 F.2d at 226; (2) *X* does not set the property for production within three taxable years of acquiring that property (notwithstanding that it is unlikely that *X* will ever set for production property that *X* retains for three years or more), *see Standley*, 99 T.C. at 272; and (3) *X* writes off for financial accounting purposes the cost of acquiring and developing the property, *see Thor Power Tool*, 439 U.S. at 542-44. Although the above facts may be relevant factors to consider, an affirmative act to abandon must be ascertained from all the facts and surrounding circumstances*, Citron*, 97 T.C. at 210. *X* retains creative properties for potential future exercise of ownership or other contractual rights, whether by sale or use, or to enforce those rights by preventing *X*'s competitors from using the property. In fact, *X* does sell or set for production some creative property after writing off the costs of such property for financial accounting purposes and having made a decision not to set the property for production. These facts are inconsistent with an intent to permanently abandon property and with an affirmative act of abandonment, both of which are required for an abandonment loss deduction under § 165(a).

Furthermore, *X* is not entitled to a worthlessness deduction in the absence of evidence of a closed and completed transaction fixed by an identifiable event establishing worthlessness. A creative property that *X* acquires may not be presumed worthless simply because *X* does not set that property for production, either by a specific internal decision or by inaction, as these are not identifiable events that irrevocably cut ties to the asset. *See Corra Resources*, 945 F.2d at 226. In addition, the facts indicate that the creative properties that *X* retains after writing off their costs for financial accounting purposes are not worthless to *X*. *X* maintains proper storage facilities for the properties, thereby preserving the properties in a condition that allows for future exercise of ownership or other contractual rights. By retaining its rights in a property, *X* can prevent a competitor from exploiting that property or prevent or defend against potential copyright infringement lawsuits. In some cases, *X* retains creative property to maintain good relations with the seller from whom *X* acquired the property. Finally, *X* retains some property in the hope that the property will have future value if the subject matter becomes more popular, if the writer becomes better known, or for various other reasons. These facts indicate that *X* has an intention to hold and preserve property because of a bona fide belief that the property has value due to the possibility that the property will be of future use. Thus, without an identifiable event that destroys the potential value and usefulness of the property to *X*, the property may not be considered worthless.

In *Situation 1*, an *X* executive's decision in 2004 not to set script *a* for production, the write-off for financial accounting purposes, and the fact that the script has not been set for production by the end of 2004 do not constitute affirmative acts of abandonment of script *a* for purposes of § 165(a), nor are they identifiable events evidencing a closed and completed transaction establishing worthlessness. To the contrary, *X*'s retention of script *a* in order to keep the potential to exercise ownership or other contractual rights in the future is evidence that the script is not worthless. Thus, in the absence of any affirmative act of abandonment or showing of worthlessness in 2004, *X* may not deduct in that year as a loss under § 165(a) the cost of acquiring and developing script *a*.

In *Situation 2*, the facts do not indicate an affirmative act of abandonment or identifiable events evidencing a closed and completed transaction establishing worthlessness until 2007. *X* may deduct *X*'s adjusted basis in screenplay *b* under § 165(a) in 2007 because *X*'s rights to screenplay *b* expire in that year. *See* Rev. Rul. 81-160, 1981-1 C.B. 312. In the absence of any affirmative act of abandonment or showing of worthlessness in an earlier taxable year, *X* may not deduct in any earlier taxable year as a loss under § 165(a) the cost of acquiring and developing screenplay *b*.

In *Situation 3*, the facts do not indicate an affirmative act of abandonment or identifiable events evidencing a closed and completed transaction establishing worthlessness. *X*'s notification to *A* of *A*'s right to reacquire motion picture rights *c* pursuant to the contract between *X* and *A* does not constitute an affirmative act of abandonment by *X* of motion picture rights *c* for purposes of § 165(a). Rather, *X* is merely complying with its contractual obligations. When *A* declines to exercise its option, *X* continues to retain motion picture rights *c* in order to keep the potential to exercise its ownership or other contractual rights in the future. Furthermore, *A*'s failure to exercise the option to reacquire motion picture rights *c* does not establish that those rights are worthless in 2005. That *A* was unable to find another studio to purchase motion picture rights *c* at a satisfactory price is also insufficient to establish the worthlessness of motion picture rights *c* in 2005. *See Proesel*, 77 T.C. at 998-99, 1006-

07. Neither of these acts is an identifiable event establishing that motion picture rights *c* are valueless in 2005 and without reasonable expectation of future value. *X*'s retention of motion picture rights *c* in order to keep the potential to exercise ownership or other contractual rights in the future is evidence that the script is not worthless. Thus, in the absence of any affirmative act of abandonment or showing of worthlessness in 2005, *X* may not deduct in that year as a loss under § 165(a) the cost of acquiring and developing motion picture rights *c*.

HOLDING

A taxpayer may not deduct the costs of acquiring and developing creative property as a loss under § 165(a) if the taxpayer does not establish an intention to abandon the property and an affirmative act of abandonment, or identifiable event(s) evidencing a closed and completed transaction establishing worthlessness.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joy Spies of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Spies at (202) 622-5020 (not a toll-free call).

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 I, §§ 446, 481; 1.446-1.)

Rev. Proc. 2004-36

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor method of accounting under which a taxpayer within the scope of this revenue procedure may amortize creative property costs (as defined in section 2.01 below) ratably over a 15-year period. This revenue procedure also provides procedures for taxpayers to obtain the automatic consent of the Commissioner of Internal Revenue to change to the safe harbor method of accounting provided in this revenue procedure.

SECTION 2. DEFINITIONS

The following definitions apply solely for the purpose of this revenue procedure:

.01 Creative property costs. Costs paid or incurred for federal tax purposes to acquire and develop screenplays, scripts, story outlines, motion picture production rights to books and plays, and other similar properties (creative properties) for purposes of potential future film development, production, and exploitation.

.02 Film. Feature films, television specials, television series, and similar products (including animated films and television programming) that are sold, licensed or exhibited, whether produced on film, videotape, digital, or other video recording format.

.03 Set for production. Management, with relevant authority, implicitly or explicitly authorizes and commits to funding the production of a film, active pre-production has begun, and the start of principal photography is expected to begin within 6 months of being set for production.

.04 SOP 00-2. The American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 00-2, "Accounting for Producers or Distributors of Films."

.05 Initial write-off. The earliest date on which the taxpayer properly writes off under SOP 00-2 any creative property costs paid or incurred with respect to a particular creative property.

SECTION 3. BACKGROUND

.01 Film studios (studios) routinely incur costs to acquire, produce, and develop creative properties. Studios may acquire these creative properties with exclusive rights of ownership, or they may have limited exploitation rights. Sometimes the rights acquired survive indefinitely while in other situations, the studios may acquire rights with a limited term. Studios ultimately set for production only a small percentage of the creative properties acquired. Most of the creative properties set for production are set within 3 years of acquisition of the property. However, studios set some properties for production that have been held for longer than 3 years. Studios do not usually discard, release to the public domain, or otherwise dispose of the creative properties not set for production or sold. Generally, studios retain these properties indefinitely.

.02 On June 12, 2000, the AICPA issued SOP 00-2, and rescinded Statement of Financial Accounting Standards No. 53. SOP 00-2 is effective for fiscal years beginning after December 15, 2000. SOP 00-2 established new generally accepted accounting principles for financial reporting purposes for the way studios account for creative property costs. SOP 00-2 states that an entity should periodically review creative properties in order to determine whether they will be used in the production of a film. SOP 00-2 states that "[w]hen an entity determines that a property will not be used (disposed of), it should recognize any loss by a charge to the income statement." SOP 00-2 further states that it is presumed that an entity will dispose of a property (whether by sale or abandonment) if it has not been set for production within 3 years from the time of the first capitalized transaction. Amounts written off should not be subsequently reestablished as assets.

.03 Section 165(a) of the Internal Revenue Code allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise.

.04 Rev. Rul. 2004-58, I.R.B. 2004-24, concludes that a taxpayer may not deduct the costs of acquiring and developing creative property as a loss under § 165(a) if the taxpayer does not establish an intention to abandon the property and an affirmative act of abandonment, or identifiable event(s) evidencing a closed or completed transaction establishing worthlessness.

.05 Thus, taxpayers generally are required under the Code and regulations to capitalize creative property costs and, unless a film is produced from the creative property, are not permitted to recover those costs through deductions for depreciation or amortization. See Rev. Rul. 79-285, 1979-2 C.B. 91. However, to minimize disputes regarding the accounting for creative property costs, the Internal Revenue Service, as a matter of administrative convenience, will allow a taxpayer that complies with the requirements of this revenue procedure to use the safe harbor amortization method described in section 5 of this revenue procedure for these costs.

SECTION 4. SCOPE

This revenue procedure applies to taxpayers engaged in the trade or business of film production that choose to account for creative property costs under the safe harbor method provided in section 5 of this revenue procedure.

SECTION 5. SAFE HARBOR METHOD

.01 In general. The Service will not challenge the use of this safe harbor method of accounting by a taxpayer within the scope of this revenue procedure provided the taxpayer follows all of the requirements of this section 5 and, if the taxpayer is changing from another method to the safe harbor method, the provisions of section 6 of this revenue procedure regarding changes in method of accounting. Under the safe harbor method, the taxpayer must amortize creative property costs properly written off by the taxpayer under SOP 00-2 ratably over an amortization period of 15 years beginning on the first day of the second half of the taxable year in which the taxpayer properly writes off the costs under SOP 00-2. For example, for a calendar-year taxpayer with a full 12-month taxable year, the first day of the second half of the taxable year is July 1st. All creative property costs that the taxpayer begins to amortize under this safe harbor method in the same taxable year are treated as a single asset. Creative property costs that the taxpayer amortizes under this safe harbor method must not be subsequently reestablished as assets, even if a particular creative property is set for production subsequent to the initial write-off. See section 5.02 of this revenue procedure for rules regarding creative property costs paid or incurred subsequent to the initial write-off, whether or not the creative property has been set for production subsequent to the initial write-off. Except as provided in section 5.03 and 5.04 of this revenue procedure, no disposition or other event accelerates recovery of the creative property costs that the taxpayer has begun to amortize under this safe harbor method.

.02 Costs paid or incurred subsequent to the initial write-off.

(1) Property not set for production. Creative property costs that are (a) associated with a particular creative property that has not been set for production and (b) paid or incurred by the taxpayer subsequent to the initial write-off must be amortized by the taxpayer (in accordance with section 5.01 of this revenue procedure) ratably over an amortization period of 15 years beginning on the first day of the second half of the taxable year in which the taxpayer pays or incurs those costs.

(2) Property set for production. Creative property costs that are (a) associated with a particular creative property that has been set for production subsequent to the initial write-off and (b) paid or incurred by the taxpayer after the property is set for production must be capitalized by the taxpayer from the time the property is set for production and depreciated using an allowable depreciation method for produced films (for example, income forecast method) at the time the property is placed in service by the taxpayer.

.03 Costs associated with property upon disposition. If, during the 15-year amortization period, creative property rights are disposed of, the taxpayer must nevertheless continue to amortize the creative property costs over the remainder of the 15-year period. A disposition includes the sale, exchange, abandonment, or destruction of creative property or the rights relating thereto. A disposition also occurs upon the expiration of a taxpayer's rights to a particular creative property. Immediately before a disposition, the creative property or creative property rights are treated as having an adjusted basis of zero for purposes of § 1011. Therefore, no loss shall be realized upon a disposition. Any amount realized on a disposition shall be recognized as ordinary income (notwithstanding any other provision of the Code). However, these rules do not apply if a taxpayer disposes of all of its creative properties, for example, as a result of a sale (not including elective recognition of gain or loss transactions under § 338(h)(10)) of its entire trade or business. Thus, in the case of a disposition of an entire trade or business, any gain from the disposition of creative property rights, the costs for which were accounted for using this safe harbor method, will be treated as ordinary income to the extent of the amortization allowed under this safe harbor method.

.04 Special rule for certain transfers. In the case of any creative property transferred in a transaction described in §§ 332, 351, 361, 721, 731, 1031, or 1033, and in any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by the group, the transferee shall be treated as the transferor for purposes of applying the safe harbor method as described in section 5 of this revenue procedure with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. However, this section 5.05 does not apply in the case of a termination of a partnership under section 708(b)(1)(B).

SECTION 6. CHANGE IN METHOD OF ACCOUNTING AND AUDIT PROTECTION

.01 Change in method of accounting. A change in a taxpayer's treatment of creative property costs is a change in method of accounting to which §§ 446(e) and 481 apply. If a taxpayer within the scope of this revenue procedure wants to change to the safe harbor method provided in this revenue procedure for creative property costs properly written off under SOP 00-2, the taxpayer must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified by Rev. Proc. 2002-19, 2002-1 C.B. 696 and Rev. Proc. 2002-54, 2002-2 C.B. 432, and as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561) or any successor, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to change to the safe harbor method described in section 5 of this revenue procedure for either its first or second taxable year ending on or after December 31, 2003;

(2) A taxpayer that wants to change to the safe harbor method described in section 5 of this revenue procedure for its first taxable year ending on or after

December 31, 2003, and that on or before July 12, 2004, files its original federal income tax return for that year, and that did not change to the safe harbor method described in section 5 of this revenue procedure on that return is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002-9, provided the taxpayer complies with the following filing requirements. The taxpayer must instead complete and file the Form 3115, Application for Change in Accounting Method, in duplicate. The original Form 3115 must be attached to an amended federal income tax return for the taxpayer's first taxable year ending on or after December 31, 2003. This amended return must be filed no later than November 29, 2004. The copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002-9 for the address) no later than when the taxpayer's amended return is filed; and

(3) For purposes of Line 1a of Form 3115, the designated number for the automatic accounting method change authorized by this revenue procedure is "85."

.02 Audit protection. If a taxpayer within the scope of this revenue procedure currently uses a method consistent with the safe harbor method described in section 5 of this revenue procedure, the method of accounting for the taxpayer's creative property costs will not be raised as an issue by the Service in a taxable year that ends before December 31, 2003. Also, if a taxpayer currently uses a method consistent with the safe harbor method described in section 5 of this revenue procedure, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, before an appeals office, or before the U.S. Tax Court for any taxable year that ends before December 31, 2003, that issue will not be further pursued by the Service.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this change in method of accounting in section 2 of the APPENDIX.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2003.

DRAFTING INFORMATION

The principal author of this revenue procedure is Lauren Ross Taylor of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Taylor at (202) 622-3040 (not a toll free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 27, 2004
JS-1694

Treasury Appoints Ira L. Hobbs to Chief Information Officer Post

The Treasury Department today announced the appointment of Ira L. Hobbs as the Department's Chief Information Officer. Hobbs comes to Treasury from the U. S. Department of Agriculture (USDA) where he has served as the Deputy Chief Information Officer for the past seven years. The appointment is effective June 13, 2004.

Hobbs has an extensive background in federal policy development and information technology (IT) program management, including a 22-year career at USDA. He has worked with the Office of Management and Budget (OMB) and the Federal CIO Council on multiple e-government initiatives and policy formulation. He has championed a myriad of cross-government initiatives to improve business processes and implement best practices. Since 1999, he has co-chaired the Federal CIO Council's Workforce and Human Capital for IT Committee.

Among his many accomplishments, Hobbs commissioned the National Academy of Public Administrators (NAPA) to study the state of the federal IT workforce. Once completed, he worked with OMB, the Office of Personnel Management, the Federal CIO Council and Congress to build a broad coalition of support for implementing the significant changes recommended by NAPA, which included changes in laws and regulations. He has a demonstrated track record of working collaboratively with others, setting a clear vision for the future and being a catalyst for change.

Hobbs has a B.A. in political science from Florida A&M University and a Master of Public Administration from Florida State University.

The Chief Information Officer (CIO) serves as the principal advisor on IT issues to the Secretary of the Treasury, the Deputy Secretary, and other senior management throughout the Department. The primary role of the CIO is to acquire and manage information resources and includes providing broad leadership in planning, budgeting, acquiring, and managing Departmental and bureau IT resources.

The CIO also formulates policies and programs to maximize the value of IT investments and manage investment risks across the Department. In partnership with the CIO Council, the CIO ensures that Department-wide and enterprise-wide corporate systems development, integration, and operational and security issues are addressed. The CIO represents Treasury's IT interests with external stakeholders, including other federal agencies, Congress and private and corporate entities.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 28, 2004
JS-1695

Statement of Treasury Secretary John W. Snow
On the Anniversary of the Jobs and Growth Tax Relief Act of 2003
May 28, 2004

One year ago this week, President Bush signed the Jobs and Growth Tax Relief Act of 2003. The passage and signing of that bill unleashed the enormous potential of our free-market economy and the results are a great victory for hardworking Americans.

Since the bill's signing, our economy has experienced a full turnaround and is firing on all cylinders. Economic indicators across the board are very strong, including three quarters of GDP growth that were the strongest in almost 20 years and the creation of 1.1 million new jobs over the past 8 months. The unemployment rate has gone down in 47 of the 50 states over the past year, and household wealth is at an all-time high.

There can be no doubt that the Jobs and Growth Tax Relief Act gave our economy the boost it needed and had a direct impact on the return of our country's extraordinary economic strength and job-creation capabilities.

Under the Jobs and Growth tax cuts, American families benefited from speeding up the income tax rate reductions, increasing the child credit, and marriage penalty relief. Small businesses – America's job creators – were helped by a reduction in tax rates on owners and entrepreneurs, and by dramatically increasing the amount they can deduct when buying new equipment.

The Jobs and Growth Tax Relief Act worked for our economy, and for Americans seeking jobs. Just one year after its signing, people are finding jobs and seeing their paychecks increase, and that kind of security is the President's top economic priority.

Congress should work with the President to ensure further economic growth by making the Jobs and Growth tax cuts permanent. Without continued tax relief that families, investors and job-creators can count on, sustained economic progress cannot be guaranteed.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 27, 2004
JS-1697

Statement of Deputy Assistant Secretary for Terrorist Financing and Financial Crimes Juan Zarate

- Juan Zarate, the Treasury Department's Deputy Assistant Secretary for Terrorist Financing and Financial Crimes, made the following statement yesterday upon the conclusion of meetings with Swiss officials engaged in the global effort to halt terrorist financing:

"Today's meetings with our Swiss counterparts allowed us to further delve into the important work underway and the challenges we face in the financial war on terror. In discussions with key Swiss officials, we reaffirmed the efforts that have reaped important successes and bolstered our collective commitment to adapt our attack to the changing face of terror. These ongoing efforts remind us that we are truly engaged in a global campaign to cut the financial ties to terrorist activity.

"We have maintained a strong working relationship with our Swiss counterparts and commend their efforts on a number of fronts, including the finding and freezing of Iraqi assets. It was with great pleasure that we received word that last week Switzerland established a critical measure putting the wheels in motion to repatriate frozen Iraqi assets to the Development Fund for Iraq (DFI).

"We have asked our Swiss counterparts, and continue to urge our partners around the globe, to remain focused on choking off dollars that fuel terrorist agendas. Though our worldwide efforts have made it harder and more costly for al Qaida and other like-minded terror groups to raise and move money, we cannot be satisfied.

"The United States remains steadfast in working methodically with our Swiss partners and those around the world committed to preventing and ending acts of terror."

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 25, 2004
JS-1698

Remarks by John B. Taylor
Under Secretary for International Affairs of the U.S. Treasury
at the Annual Meetings of the African Development Bank
May 25, 2004

President Kabbaj, fellow Governors, ladies and gentleman, on behalf of Secretary Snow, I would like to thank the Government of Uganda and Minister Ssendaula for hosting this momentous meeting. It is an honor for me to join you in celebrating the fortieth anniversary of the African Development Bank.

Economic Development Agenda of the United States

Since the beginning of President Bush's time in office, he has stressed four core principles in U.S. development policy. Financial assistance for the poorest countries should be increased. More assistance should be provided in the form of grants. Development assistance should be subject to rigorous measurable results. And support should be targeted to countries that pursue pro-growth policies.

Implementation at the African Development Bank

We have worked together with African Development Bank Management and many other countries to implement these principles. And we are very pleased that this cooperative effort has worked so well at the AfDB. Over the past several years, under President Kabbaj's leadership, the Bank has demonstrated an impressive willingness and ability to reform. We are cautiously optimistic that these changes will be sustained. Let me be specific.

Increasing Financial Assistance for the Region's Poorest Countries

The United States increased its contributions to both the African Development Fund and IDA by 18 percent over the previous replenishments. And we may consider the possibility of additional support in the next replenishment to the extent that the African Development Fund is becoming more focused on delivering meaningful results for the people of Africa. Our expanded support for the AfDF is congruent with the Bush Administration's dramatic increase in support to fight HIV/AIDS and expansion of bilateral U.S. assistance to the best performing poorest countries through its new assistance program -- the Millennium Challenge Account (MCA).

A special category among the poorest countries is post-conflict countries. In the last 10 years, more than one-third of Sub-Saharan Africa's countries have experienced major civil conflict. The countries often emerge from conflict with inadequate institutional capacity, weakened infrastructure, and excessive external debt, including arrears to the AfDB. We commend the Bank's initiative in developing a framework to help clear arrears of post-conflict heavily indebted poor countries (HIPCs). Countries like the Republic of Congo and Central African Republic could benefit from such a framework as they attempt to normalize relations with official donors and establish economic stability.

Increased Grant Assistance

During a recent trip to Africa, I visited several grant-financed projects, including an AfDF project in Senegal to train middle school teachers. Throughout my trip, my conversations with health professionals, village chiefs, and parents of schoolchildren made me all the more convinced that grants are critical to heavily indebted poor countries. I was struck by their enthusiasm over the benefits of grant financing, particularly that grants eliminate bureaucratic hurdles.

Grants reduce the probability of poor countries experiencing debt distress. As we are seeing in the cases of Niger and Ethiopia, countries' debt levels remain at unsustainable levels, despite HIPC debt relief and additional "topping up" assistance. Grants free up scarce public resources, which would otherwise have been used to pay off outstanding loan commitments. These resources can be used to fund the kind of productive investments that President Museveni described this morning, such as infrastructure improvements and agricultural programs, which contribute to economic growth and poverty reduction.

During the upcoming AfDF-10 replenishment discussions, I urge donors to carefully evaluate the debt levels and tremendous development needs of AfDF countries before developing a final view on grant funding in AfDF-10.

Rigorous Measurable Results

The U.S. applauds the Bank's progress in putting in place a strong results management system aimed at securing improvements in people's lives. A good example of what can be done is the AfDF project in Senegal that is training middle school teachers. This grant is being used to train 3,000 middle school teachers and its aim is to reduce middle school repetition rates from 15% in 1998 to 10% in 2004. Such progress makes meaningful changes in people's lives. We urge the Bank to ensure that such quantifiable and monitorable indicators are rigorously incorporated at the project, country and institutional levels.

Encouraging Pro-Growth Policies

For 2004, average real GDP growth rate in Africa is projected to be 4.5% and expected to rise to 5.5% in 2005. Part of the increased growth can be attributed to a better policy environment. Throughout Africa, countries have strengthened their macroeconomic policy framework in order to create an environment conducive to strong private sector-led economic growth. However, the strong growth rates are also functions of increased oil production, higher commodity prices and favorable weather. In order to sustain economic growth rates at levels which would significantly reduce poverty in Africa and to reduce economic vulnerability to exogenous shocks, Africa must continue to promote policies and institutions which promote private investment. Some countries are already promoting such policies. For example, Benin has made a concerted effort to improve financial intermediation which has led to a fully private banking system. Cape Verde recently lowered corporate and income tax rates in order to improve its investment climate.

Our host country, Uganda, is another good example. For the last 15 years, Uganda demonstrated commitment to economic reform, averaging 7% growth rate per year and reducing the proportion of its population living below the poverty line from 56% in 1992 to 38% in 2002/03. The country has sustained macroeconomic stability and effectively channeled donor assistance to promote economic growth. In order to sustain this economic growth rate, Uganda has worked to diversify its economy, attract private investment and improve service delivery.

To support and reinforce these pro-growth policies, all the multilateral development banks have in place a system to allocate assistance to countries based on a range of indicators that include governance, portfolio performance and country needs. The AfDF is similarly implementing a performance-based allocation system that targets Fund resources to those countries that can use this assistance most effectively.

As President Museveni described so eloquently this morning, a strong private sector is critical to economic growth and poverty reduction. Support for small enterprises is particularly important. No country has achieved sustainable growth without a robust small business sector and no country can hope to foster innovation and generate jobs without small business growth. Recognizing this, the Ghanaian Government implemented reforms to reduce the number of days to start a business by 35% in just one year.

In this context, we call upon the Bank to rejuvenate its approach to supporting the private sector. In particular, we urge the Bank Group to find more innovative approaches to support small- and medium-sized enterprise development beyond extending lines of credit, perhaps via great technical assistance to banks to help them better analyze small credit risks. That said, we want to very much welcome the Bank's franchising initiative that will soon be launched in South Africa, and hopefully, elsewhere on the continent.

Conclusion

At the conclusion of his trip last July, President Bush called Africa "a continent of possibilities." The more I travel throughout Africa, the more I see those possibilities. I see the possibility for stronger economic growth, greater private sector involvement, and improved social service delivery systems to ensure that children can receive good educations and live long prosperous lives. Our responsibility as donors is to push for assistance which is more effective in delivering meaningful results without saddling countries with more debt they cannot repay. We appreciate the progress that the AfDB has made in these areas and look forward to strengthening our partnership for reform even further.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 28, 2004
JS-1696

Statement of Juan Zarate after Meeting with Russian Ministries of Finance and Foreign Affairs

Moscow, RUSSIA - Juan Zarate, the Treasury Department's Deputy Assistant Secretary for Terrorist Financing and Financial Crimes, made the following statement upon the conclusion of meetings with officials from the Russian Ministries of Finance and Foreign Affairs:

"The U.S. Department of the Treasury and the Russian Finance Ministry today set out an ambitious agenda to partner in the international fight against terrorist financing and money laundering. This partnership is an important element in the overall counter-terrorism cooperation between the United States and the Russian Federation, and this meeting provided the foundation for a report to President George Bush and President Vladimir Putin on specific joint action being undertaken by both Departments. The strengthening of this partnership is both vital and timely, as it parallels current efforts by both the Treasury and Finance Ministry to bolster and expand capabilities, allowing us to more effectively combat terrorist financing."

"Among the specific items of discussion was the agreement by both Departments to work together in identifying foreign banks that are involved in terrorist financing, money laundering and other illicit activities. Treasury and the Finance Ministry also discussed an initiative to ensure that the countries of Central Asia have the necessary capacities to fight the financial war on terror."

"The United States and the Russian Federation have forged a strong relationship, and the cooperation and resolution between the Treasury and Finance Ministry enhances this partnership. We look forward to reaping the benefits of this cooperation as we continue to battle the ever-evolving face of terrorism throughout the globe."

8412 8286 19
06/29/05 MAB
ICBINDING

U.S. TREASURY LIBRARY
10117604