Internal Revenue
bulletin

Bulletin No. 2002–21
May 28, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–30, page 971.
Notional principal contract. This ruling provides that where a nonperiodic payment made pursuant to a notional principal contract is comprised of noncontingent and contingent components, the parties must recognize the noncontingent component of the nonperiodic payment over the term of the notional principal contract.

T.D. 8992, page 981.
Final regulations under section 6050S relate to information reporting, including magnetic media reporting requirements for payments of interest on qualified education loans (Form 1098–E) and the continuation of Notice 98–7 for the calendar year 2002.

REG–161424–01, page 1010.
Proposed regulations under section 6050S relate to information reporting, including magnetic media reporting for qualified tuition and related expenses (Form 1098–T) and the continuation of Notice 97–73 for the calendar year 2002. A public hearing is scheduled for August 13, 2002. REG–105316–98 withdrawn.

Notice 2002–35, page 992.
Notional principal contract tax shelter. The Service may challenge transactions using notional principal contracts to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting payments in the future. These transactions are designated as "listed transactions" for purposes of sections 1.6011–4T(b)(2) and 301.6111–2T of the regulations.

Rev. Proc. 2002–36, page 993.
Methods of accounting; taxable year of inclusion; basis. This procedure provides taxpayers that purchase vehicles subject to leases and assume the associated leases from motor vehicle dealers with a safe harbor method of accounting for capital cost reduction payments made by vehicle lessees, and a procedure for taxpayers to obtain automatic consent of the Commissioner to change to the safe harbor method of accounting. Rev. Proc. 2002–9 modified and amplified.

EMPLOYEE PLANS

REG–136193–01, page 995.
Proposed regulations under section 4980F of the Code provide guidance on the requirements for plan administrators to give notice of plan amendments that provide for significant reduction in the rate of future benefit accrual or an early retirement benefit or retirement-type subsidy. When finalized, the regulations will affect businesses, nonprofit organizations, and individuals. A public hearing is scheduled for August 15, 2002.

Notice 2002–32, page 989.
Weighted average interest rate update. The weighted average interest rate for May 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

T.D. 8991, page 972.
Final regulations under section 513 of the Code provide guidance concerning whether corporate sponsorship payments to tax-exempt organizations are unrelated business taxable income.

Notice 2002–34, page 990.
This notice announces and provides guidance for a voluntary compliance program to promote disclosure for political organizations that file Forms 8871, 8872, 1120–POL, 990, and 990–EZ by July 15, 2002.

ADMINISTRATIVE

Notice 2002–33, page 989.
Section 809 information return. This notice suspends the requirement that mutual life insurance companies and the 50 largest stock life insurance companies file Form 8390, *Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809*, in 2002 and 2003 due to section 809(j) which was added to the Code by the Job Creation and Workers Assistance Act of 2002.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 61.—Gross Income Defined

26 CFR 1.61–1: Gross income.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

26 CFR 1.446–3: Notional Principal Contracts.

Notional Principal Contract. This ruling provides that where a nonperiodic payment made pursuant to a notional principal contract is comprised of noncontingent and contingent components, the parties must recognize the noncontingent component of the nonperiodic payment over the term of the notional principal contract.

Rev. Rul. 2002–30

ISSUE

What is the appropriate method for the inclusion into income or deduction of a nonperiodic payment made pursuant to a notional principal contract where the payment is comprised of noncontingent and contingent components?

FACTS

T enters into a notional principal contract ("NPC") with *CP* on October 1, 2002, for a term of 18 months. Pursuant to the terms of the NPC, *T* agrees to make quarterly payments to *CP* based on three-month LIBOR multiplied by a notional principal amount of $100,000,000. In exchange, *CP* agrees that upon expiration of the NPC on March 31, 2004, *CP* will pay *T* 6 percent per year multiplied by a notional principal amount of $92,000,000 (the fixed payment amount). In addition, *CP* or *T* will make a payment upon expiration equal to the percentage change in the value of the S&P 500 stock index multiplied by a notional principal amount of $8,000,000. If the change is positive (an appreciation amount), *CP* will make a payment to *T*; if the change is negative (a depreciation amount), *T* will make a payment to *CP*. Any depreciation amount payable by *T* will be netted against the fixed payment amount payable by *CP*.

LAW

Section 1.446–3 of the Income Tax Regulations provides rules on the timing of inclusion of income and deductions for amounts paid or received pursuant to NPCs.

Section 1.446–3(c)(1)(i) defines a NPC as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts. Payments made pursuant to NPCs are divided into three categories (periodic, nonperiodic, and termination payments), and the regulations provide separate timing regimes for each.

Section 1.446–3(e)(1) defines periodic payments as payments made or received pursuant to a NPC that are payable at intervals of one year or less during the entire term of the contract, that are based on a specified index, and that are based on a notional principal amount. Section 1.446–3(e)(2) provides that all taxpayers, regardless of their methods of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

Section 1.446–3(h)(1) defines a termination payment as a payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a NPC.

Section 1.446–3(f)(1) provides that a nonperiodic payment is any payment made or received with respect to a NPC that is not a periodic payment or a termination payment. The recognition rules for nonperiodic payments are set forth in § 1.446–3(f)(2). Section 1.446–3(f)(2)(i) provides that all taxpayers, regardless of their methods of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract.

Section 1.446–3(f)(2)(ii) provides generally that a nonperiodic payment must be recognized over the term of the contract by allocating it in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.

Section 1.446–3(f)(2)(iii)(A) provides that an upfront payment may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method).

Section 1.446–3(f)(2)(iii)(B) provides that nonperiodic payments other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The single upfront payment is then amortized under the level payment method described in § 1.446–3(f)(2)(iii)(A). The time value component of the loan is not treated as interest, but together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. *See* § 1.446–3(f)(4), Example 6, for an illustration of these rules.

Section 1.446–3(g)(4) provides that a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap under § 1.446–3(d) of this section, but is recognized as interest for all purposes of the Internal Revenue Code.

Section 1.446–3(d) provides that for all purposes of the Code, the net income or net deduction from a NPC for a taxable year is included in, or deducted from, gross income for that taxable year. The net income or net deduction from a NPC for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under § 1.446–3(e), and all of the nonperiodic payments that are recognized from that contract for the taxable year under § 1.446–3(f). Each party to the NPC determines its payments and receipts attributable to the taxable year and takes into account, as net income or net deduction, the result of those payments and receipts. *See* § 1.446–3(e)(3), Example 1; and § 1.446–3(g)(6), Example 3.

ANALYSIS

The agreement between *T* and *CP* is a NPC as defined in § 1.446–3(c)(1)(i). Pursuant to the terms of the contract, *T* will pay to *CP* amounts based on LIBOR quarterly, in exchange for *CP*'s promise to pay specified consideration at expiration.

The amounts that *T* pays to *CP* are periodic payments as defined in § 1.446–3(e)(1). These LIBOR-based payments are payable at intervals of less than one year and are calculated by reference to a specified index upon a notional principal amount of $100,000,000. Pursuant to § 1.446–3(e)(2), *T* and *CP* must recognize the ratable daily portion of each periodic payment for the taxable year to which that portion relates.

The amount payable on March 31, 2004, is a nonperiodic payment, which *T* and *CP* are required to recognize over the term of the NPC in a manner that reflects the economic substance of the NPC. In substance, the nonperiodic payment that *CP* must pay *T* on expiration equals the sum of two independent components, one noncontingent and the other contingent. The noncontingent component (the fixed payment amount) equals $8,280,000, that is the product of 6 percent per year, or 9 percent for 18 months, and the notional principal amount of $92,000,000. The contingent component (the appreciation or depreciation amount) equals the product of the percentage appreciation or depreciation in the value of the S&P 500 stock index and the notional principal amount of $8,000,000. In order to reflect the economic substance of the NPC, each component must be treated separately for purposes of applying the NPC rules in § 1.446–3. As a result, pursuant to § 1.446–3(f)(2)(i), the fixed payment amount due on March 31, 2004, must be recognized over the term of the NPC in a manner consistent with § 1.446–3(f)(2)(ii) or (iii). This treatment of the fixed payment amount payable by *CP* is not affected by the possibility that *T* may be required to pay a depreciation amount to *CP* that, under the terms of the NPC, will be netted against *CP*'s obligation to pay the fixed payment amount. Pursuant to § 1.446–3(g)(4), *T* must accrue interest income and *CP* may accrue interest deductions.

HOLDING

T and *CP* must recognize the noncontingent component of the nonperiodic payment over the term of the NPC, and must also account for interest, in a manner consistent with §§ 1.446–3(f)(2)(ii) or (iii), and 1.446–3(g)(4).

DRAFTING INFORMATION

The principal author of this revenue ruling is Elizabeth Handler of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Handler at (202) 622–3930 (not a toll-free call).

Section 451.—General Rule for Taxable Year of Inclusion

26 CFR 1.451–1: General rule for taxable year of inclusion.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

Section 481.—Adjustments Required for Changes in Method of Accounting

26 CFR 1.481–1: Adjustments in general.
26 CFR 1.481–4: Adjustments taken into account with consent.

A purchaser of a motor vehicle that is subject to a lease in connection with which a lessee has made a CCR payment to the dealer from which the lessee originally leased the vehicle may obtain automatic consent to change to the CCR method of accounting. See Rev. Proc. 2002–36, page 993.

Section 513.—Unrelated Trade or Business

26 CFR 1.513–4: Certain sponsorship not unrelated trade or business.

T.D. 8991

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Taxation of Tax-Exempt Organizations' Income From Corporate Sponsorship

AGENCY: Internal Revenue Service (IRS), Treasury Department.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of corporate sponsorship payments received by tax-exempt organizations. The final regulations affect exempt organizations that receive sponsorship payments.

DATES: *Effective Date*: These regulations are effective April 25, 2002.

Applicability Date: These regulations are applicable for payments solicited or received after December 31, 1997.

FOR FURTHER INFORMATION CONTACT: Stephanie Lucas Caden or Barbara E. Beckman of Office of Associate Chief Counsel (TE/GE), (202) 622–6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Exempt organizations generally must pay tax on unrelated business taxable income, as defined in section 512. Section 512(a)(1) defines *unrelated business taxable income* (UBTI) as the gross income derived by an organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions that are directly connected with the carrying on of the trade or business, both computed with the modifications provided in section 512(b).

Section 513(a) defines *unrelated trade or business* as any trade or business the conduct of which is not substantially related (aside from the need of an 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 section 501. Section 513(c), captioned "Advertising, etc., activities," provides that the term *trade or business* includes any activity carried on for the production of income from the sale of goods or the performance of services, and that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. See § 1. 513–1(b).

The IRS first published a notice of proposed rulemaking (EE–74–92, 1993–1 C.B. 708) (1993 proposed regulations) on January 22, 1993 (58 F.R. 5687), proposing that the regulations under section 513 be amended to provide guidance on the proper tax treatment of sponsorship payments received by an exempt organization. The 1993 proposed regulations focused on the nature of the services provided by the exempt organization rather than the benefit received by the sponsor, and distinguished advertising, which is an unrelated trade or business activity, from acknowledgments, which are the mere recognition of a sponsor's payment and therefore do not result in UBTI. In a so-called "tainting rule," the 1993 proposed regulations provided that if any activities, messages or programming material constituted advertising with respect to a sponsorship payment, then all related activities, messages, or programming material that might otherwise be acknowledgments would be considered advertising. The 1993 proposed regulations also proposed to amend the regulations under section 512(a) by adding examples of the allocation rule governing exploitation of exempt activities in cases involving sponsorship income.

The Taxpayer Relief Act of 1997, Public Law 105–34, section 965 (111 Stat. 788, 893–94), amended the Internal Revenue Code (Code) by adding section 513(i). Section 513(i) governs the treatment of certain sponsorship payments by providing that qualified sponsorship payments are not subject to the unrelated business income tax (UBIT). Section 513(i) defines *qualified sponsorship payments* as payments made by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the exempt organization's activities. Section 513(i) further provides that use or acknowledgment does not include advertising (including messages containing qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use a sponsor's products or services).

Section 513(i) specifically provides that, to the extent a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, that portion of such payment and the other portion of such payment are treated as separate payments. Whether a separate transaction that falls outside of the section 513(i) safe harbor is subject to the UBIT depends on the application of existing rules under sections 512, 513, and 514.

Section 513(i) applies to payments solicited or received after December 31, 1997. Section 513(i) does not apply to qualified convention and trade show activities (described in section 513(d)(3)(B)) or to the sale of an acknowledgment or advertising in exempt organization periodicals. For this purpose, the term *periodicals* means regularly scheduled and printed material published by or on behalf of an exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization.

To reflect the differences between the 1993 proposed regulations and section 513(i), and in response to comments submitted on the 1993 proposed regulations, new proposed regulations (REG–209601–92, 2000–1 C.B. 829) (2000 proposed regulations) were issued on March 1, 2000 (65 F.R. 11012).

The 2000 proposed regulations amend the regulations under section 513, and provide that qualified sponsorship payments within the meaning of section 513(i) are not UBTI. The 2000 proposed regulations define the phrase "substantial return benefit" to mean any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value under existing IRS guidelines. Generally, according to the 2000 proposed regulations, benefits such as complimentary tickets, pro-am playing spots, and receptions for donors have an insubstantial value only if they have a fair market value of not more than 2% of the payment, or $74 (adjusted for inflation for tax years beginning after calendar year 2000 pursuant to section 1(f)(3)), whichever is less. See § 1.170A–13(f)(8)(i)(A); Rev. Proc. 90–12 (1990–1 C.B. 471), as adjusted for inflation (for calendar year 2002, the amount is $79, see Rev. Proc. 2001–59 (2001–52 I.R.B. 623) (December 26, 2001)).

The 2000 proposed regulations clarify that for an exempt organization to avail itself of the section 513(i) safe harbor, it must establish that some portion of the payment exceeds the fair market value of any substantial return benefit received by a payor in return for making the payment. In a sponsorship arrangement, the fair market value of the substantial return benefit may equal the entire amount of the sponsorship payment. The burden of establishing the fair market value of any substantial return benefit falls on the exempt organization. The 2000 proposed regulations state that the exempt organization's determination of the fair market value of a substantial return benefit provided to the payor will not be set aside for purposes of applying the section 513(i) safe harbor so long as the organization makes a reasonable and good faith valuation of the substantial return benefit received by the payor.

The 2000 proposed regulations provide that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business, or industry is generally not a substantial return benefit. Any portion of the payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, if in return for a payment, the exempt organization agrees that products or services that compete with the payor's products or services will not be sold or provided in connection with one or more activities of the exempt organization, the payor has received a substantial return benefit and the portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment. Consistent with the allocation rule described above, when a payor receives both exclusive sponsorship and exclusive provider rights in exchange for making a payment, the fair market value of the exclusive provider arrangement and any other substantial return benefit is determined first (*i.e.*, without regard to the existence of the exclusive sponsorship arrangement).

The 2000 proposed regulations clarify that qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or section 509(a)(2). The exclusion of contributed services for purposes of determining public support is consistent with the general rule regarding donated services. See §§ 1.509(a)–3(f), 1.170A–9(e)(7)(i) and 1.170A–1(g).

A public hearing was held on June 21, 2000. After consideration of all the comments, the proposed regulations under section 513(i) are revised as follows. The major areas of the comments and revisions are discussed below.

Explanation of Provisions and Discussion of Comments

Like the 2000 proposed regulations, the final regulations define the phrase *substantial return benefit* to mean any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value. If a payor receives a substantial return benefit in exchange for a payment, the section 513(i) safe harbor does not apply to the payment (or portion thereof) attributable to the substantial return benefit. In that case, whether the payment (or portion thereof) is subject to UBIT must be determined under existing principles and rules. Thus, the payment may not be subject to UBIT because the exempt organization's activity is not an unrelated trade or business within the meaning of section 513(a) (for example, because substantially all of the work in carrying on the trade or business is performed by volunteers) or is not regularly carried on within the meaning of section 512(a)(1), or because one of the section 512(b) modifications applies. See also Rev. Rul. 77–367 (1977–2 C.B. 193) (inurement) and Rev. Rul. 66–358 (1966–2 C.B. 218) (private benefit).

Many comments were received regarding the disregarded benefits standard contained in the 2000 proposed regulations. Commentators generally believe that valuing insubstantial benefits places an undue administrative burden on exempt organizations. Commentators also believe that the disregarded benefits standard in the proposed regulation is too low and significantly diminishes an exempt organization's ability to appropriately thank its sponsors. While the $79 ceiling (as adjusted for 2002) is an appropriate amount for exempt organizations to thank individual donors, the Treasury Department and IRS agree with the commentators that the $79 ceiling is too low with respect to corporations or persons engaged in a trade or business. In response to these concerns, the final regulations eliminate the $79 ceiling placed on the fair market value of benefits that may be disregarded for purposes of section 513(i).

Several commentators suggest that in addition to eliminating the $79 ceiling, the final regulations should increase the level of disregarded benefits to 10% or 15% of the amount of the payment. The Treasury Department and IRS believe 2% is an appropriate level for several reasons. The 2% threshold is used in other areas of the Code and regulations to describe insubstantial amounts. The 2000 proposed regulations allow the full amount of qualified sponsorship payments (except for payments in the form of services) to be treated as contributions for purposes of the public support test under sections 170(b)(1)(A)(vi) and 509(a)(2), without reduction for the amount of disregarded benefits. The 2% ceiling keeps the level of disregarded benefits low enough so that the entire amount of a qualified sponsorship payment may be treated as a contribution for public support purposes. Accordingly, the final regulations disregard benefits having a fair market value of not more than 2% of the payment.

Many commentators to the 2000 proposed regulations object to a requirement that exempt organizations must value benefits provided to payors where the payment does not affect the organization's tax liability, *e.g.*, where the payment attributable to the benefit constitutes income from a trade or business that is substantially related to the organization's exempt purposes. The Treasury Department and IRS note that organizations described in section 170(c) (other than section 170(c)(1)) are required to account for benefits provided to donors under section 6115. See Publication 1771, "*Charitable Contributions—Substantiation and Disclosure Requirements.*" Pursuant to section 6115, a section 170(c) organization that receives a quid pro quo contribution in excess of $75 is required to inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the amount by which the payment exceeds the value of goods or services (except as provided in § 1.170A–13(f)(8)(i)) furnished by the charity, and is required to provide a good faith estimate of the value of those goods or services. Therefore, for exempt organizations eligible to receive tax deductible contributions, there is no additional tax administrative burden imposed by the disregarded benefits provision of either the 2000 proposed regulations or the final regulations.

The final regulations provide that in determining whether the 2% threshold has been exceeded in any year, all return benefits (other than use or acknowledgment) must be considered. For example, if in exchange for a payment the exempt organization provides both a license and advertising the combined fair market value of which does not exceed 2% of the total payment, the entire payment (even the portion attributable to the advertising) may be treated as a qualified sponsorship payment, and the entire amount (except any payment in the form of services) constitutes public support under section 509. Alternatively, if the combined fair market value exceeds 2% of the total payment, the value of both the license and advertising is not disregarded and constitutes a substantial return benefit. In that case, the portions of the payment attributable to the license and advertising each must be analyzed separately under sections 512, 513, and 514. Only the portion of the payment, if any, that exceeds the fair market value of the substantial return benefit constitutes a qualified sponsorship payment.

Consistent with the 2000 proposed regulations, the final regulations provide that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business or industry is generally not a substantial return benefit. The portion of any payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, if in return for a payment, the exempt organization agrees that products or services that compete with the payor's products or services will not be sold or provided in connection with one or more activities of the exempt organization, the payor has received a substantial return benefit and the portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment.

Some commentators express concern that the definition of exclusive provider arrangements contained in the 2000 proposed regulations may include vendor contracts negotiated as part of a competitive bidding process required by state law. Both the 2000 proposed regulations and the final regulations provide that unless the exempt organization agrees to limit distribution of competing products in connection with the payment, the exempt organization has not entered into an exclusive provider arrangement. For example, when the nature of the goods or services to be provided necessitates the use of only one provider because of limited space or because the competitive bidding process requires only the lowest bid be accepted, the exempt organization has not entered into an exclusive provider arrangement unless it agrees to limit distribution of competing products.

In particular, these commentators express concern about the tax-treatment of discounts and rebates negotiated with vendors as part of the competitive bidding process. Generally, discounts (and rebates) are considered an adjustment to the purchase price and do not constitute gross income to the purchaser. See Rev. Rul. 84–41 (1984–1 C.B. 130); Rev. Rul. 76–96 (1976–1 C.B. 23). For example, when a university negotiates discounted rates for the soft drinks it purchases for its cafeterias, snack bars, and concessions, the amount of the discount is not includible in UBTI.

Many commentators suggest that the exclusive provider provisions in the 2000 proposed regulations create an implication that exclusive provider arrangements are automatically subject to UBIT because they fall outside the scope of section 513(i). This assumption is incorrect; although the income from some exclusive provider arrangements may be includible in UBTI, not all contracts will meet the criteria for inclusion in UBTI pursuant to sections 511, 512, and 513. For example, a university that enters into a multi-year contract with a soft drink company to be the exclusive provider of soft drinks on campus in return for an annual payment is not necessarily subject to UBIT on that payment. If the company agrees to provide, stock, and maintain on-campus vending machines as needed, leaving little or no obligation on the university's part to perform any services or conduct activities in connection with the enterprise, then based on this contract alone the university may not have the requisite level of activity to constitute a trade or business under section 513(a). This example assumes no agency relationship exists between the company and the university. In determining the level of activity, however, any promotional or marketing efforts by the university pursuant to the contract should be considered. If the contract grants the company a license to market its products using the university's name and logo, the portion of the total payment attributable to the value of the license may be excludable as a royalty under section 512(b)(2). In some cases, payments in connection with the grant of an exclusive concession, such as for the operation of a campus bookstore or cafeteria, may be treated as rental income under section 512(b)(3).

When an exempt organization agrees to perform substantial services in connection with the exclusive provider arrangement, income received by the organization may be includible in UBTI. For example, assume that a university enters into a multi-year contract with a sports drink company under which the company will be the exclusive provider of sports drinks for the university's athletic department and concessions. As part of the contract, if the university agrees to perform various services for the company, such as guaranteeing that coaches make promotional appearances on behalf of the company (*e.g.*, attending photo shoots, filmed commercials, and retail store appearances), assisting the company in developing marketing plans, and participating in joint promotional opportunities, then the university's activities are likely to constitute a regularly carried on trade or business. These activities are unlikely to be substantially related to the university's exempt purposes. Furthermore, the income received by the university for those services is not excludable as a royalty under section 512(b)(2). See Rev. Rul. 81–178 (1981–2 C.B. 135), situation 2.

The 2000 proposed regulations solicited comments on the application of the rules governing periodicals and trade shows to an exempt organization's Internet sites, and whether providing a link to a sponsor's Internet site is advertising within the meaning of section 513(i). The comments received generally suggest that a link to a corporate sponsor's Internet site as part of a sponsorship arrangement is not a message, but a convenient feature of the Internet that can only be activated by the viewer, and thus constitutes a permissible form of acknowledgment. With regard to periodicals, most commentators expressed the view that the term "periodical", for purposes of the section 513(i) exclusion, includes material published electronically. Some commentators suggest that an exempt organization's Internet site should not be treated as a periodical simply because it has text that changes from time to time. Other commentators suggest criteria for analyzing whether an Internet site is a periodical.

Only a few comments were received on the application of the trade show exclusion in section 513(i) to an exempt organization's Internet site. These comments generally suggest that trade shows conducted over the Internet be treated the same as trade shows conducted in person. That is, payments made in connection with Internet-based trade shows would not be exempt from UBIT as qualified sponsorship payments, but would be exempt from UBIT as income generated by qualified convention and trade show activity.

Many options for addressing the Internet in the final regulations were considered. The final regulations take the approach that, where possible, answers are provided. However, the Treasury Department and IRS note that the analysis of particular Internet issues, such as the use of hyperlinks, may be different for purposes of section 513(i) than other sections of the Code. The Treasury Department and IRS also conclude that some Internet issues addressed in comments are beyond the scope of section 513(i).

For purposes of section 513(i), the issue of whether a hyperlink constitutes an acknowledgment or advertising is addressed in the final regulations with two new examples. In the first new example, the exempt organization posts a list of its sponsors on its website, including the sponsor's Internet address, which appears as a hyperlink from the exempt organization's website to the sponsor's website. The example concludes that posting the sponsor's website address constitutes an acknowledgment, even though it appears as a hyperlink. In the second new example, a charity maintains a website that contains a hyperlink to a sponsor's website where an endorsement by the charity for the sponsor's product appears. The charity approved the endorsement before it was posted on the sponsor's website. The example concludes that the endorsement is advertising. These two examples address hyperlinks for purposes of section 513(i) only, and do not suggest how hyperlinks are treated under other sections of the Code.

With respect to periodicals, section 513(i) mentions periodicals only in the sense that the safe harbor does not apply to any payment which entitles the payor to the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in exempt organization periodicals. Such payments are analyzed instead under the existing UBIT rules. Section § 1.512(a)–1(f) provides special rules for determining the amount of UBTI attributable to the sale of advertising in exempt organization periodicals. After considering the comments, the Treasury Department and IRS conclude that the regulations under section 512 are the more appropriate place for an analysis of issues relating to electronic periodicals. Nevertheless, the Treasury Department and IRS clarify that periodicals may include some forms of electronic publication. The final regulations state that the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization, and for this purpose, printed material includes material that is published electronically.

As noted above, relatively few comments were received on the trade show exclusion. Because of the small sampling of comments received, and because trade show rules impact many different industries and typically involve large sums of money, the final regulations do not change the rules on what constitutes a qualified convention and trade show activity. Existing guidance on trade shows is found in section 513(d) and § 1.513–3, and any reference to trade shows in the final regulations under section 513(i) is intended to be consistent with these rules.

Many commentators wrote regarding the valuation of substantial return benefits, and suggest that the 2000 proposed regulations do not offer enough guidance on how to make a reasonable and good faith valuation of a substantial return benefit. Commentators also assert that the valuation provisions do not further administrative convenience and simplicity. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement. While the Treasury Department and IRS appreciate the difficulty an exempt organization has in valuing substantial return benefits, the final regulations retain the valuation standard contained in the 2000 proposed regulations. Several commentators suggest incorporating safe harbors into the final regulations to determine the value of a substantial return benefit. For example, one commentator suggests that a safe harbor be added to provide that an exempt organization's valuation would not be challenged if it were determined based on the face amount of the tickets, cost of the dinner, or any reasonably comparable measure. Another commentator suggests that the fair market value be based on data provided by the payor, or as agreed by the parties. Another commentator favors predicting values of yearly benefits based on actual benefits provided over a three-year period. After considering these comments, the Treasury Department and IRS conclude that the safe harbors suggested by the commentators either are inconsistent with the general rule, do not provide any additional guidance, or are prone to abuse. For this reason, no safe harbors were added to the final regulations with respect to valuation.

Clarification is provided, however, with respect to the valuation date. The 2000 proposed regulations provide that in allocating a sponsorship payment, the fair market value of the substantial return benefit is to be determined on the date the parties enter into the sponsorship arrangement. The final regulations take the same approach for binding, written sponsorship contracts. This rule, which is illustrated by two new examples, provides exempt organizations the advantage of only having to value substantial return benefits once, even if the value of the substantial return benefit increases over the term of the contract. If the parties make a material change to a sponsorship contract, it is treated as a new contract as of the date the material change is effective. A material change is defined as an extension or renewal of the contract, or a more than incidental change to any amount payable (or other consideration) under the contract. If there is no binding, written contract, the fair market value of the substantial return benefit is determined when the benefit is provided. The reason for distinguishing between written and oral agreements in the final regulations is to allow smaller exempt organizations to arrange sponsorship informally on a year-to-year basis and value those benefits each year as they occur.

Few comments were received on the § 1.512(a)–1(e) example relating to expense allocation. Of the comments received, most state that the 1993 proposed regulations did not interpret the exploitation exception too broadly, and request that the prior examples be reinstated. The commentators also suggest that the new example is factually unrealistic. Despite these comments, the final regulations do not change the § 1.512(a)–1(e) example. The comments received generally do not contain substantive suggestions for change, and the Treasury Department and IRS believe that the current example in the final regulations correctly amplifies the technical provisions of the regulation, which is very limited in scope.

Special Analyses

It has been determined that this 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 final rule does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these regulations were previously submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Stephanie Lucas Caden, Office of Division Counsel/Associate Chief Counsel (Tax Exempt/Government Entities), Internal Revenue Service. However, personnel from other offices of the Service and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.170A–9, a sentence is added to the end of paragraph (e)(6)(i) to read as follows:

§ 1.170A–9 Definition of section 170(b)(1)(A) organization.

* * * * *

(e) * * *

(6) * * * (i) * * * For purposes of this paragraph (e), the term *contributions* includes qualified sponsorship payments (as defined in § 1.513–4) in the form of money or property (but not services).

* * * * *

Par. 3. Section 1.509(a)–3 is amended by:

1. Adding a sentence to the end of paragraph (f)(1).

2. Revising the paragraph heading and introductory text for paragraph (f)(3).

3. Redesignating the current *Example* in paragraph (f)(3) as *Example 1* and revising the heading.

4. Adding *Example 2* and *Example 3* to paragraph (f)(3).

The revisions and additions read as follows;

§ 1.509(a)–3 Broadly, publicly supported organizations.

* * * * *

(f) * * * (1) * * * For purposes of section 509(a)(2), the term *contributions* includes qualified sponsorship payments (as defined in § 1.513–4) in the form of money or property (but not services).

* * * * *

(3) *Examples*. The provisions of this paragraph (f) may be illustrated by the following examples:

Example 1. * * *

Example 2. Q, a performing arts center, enters into a contract with a large company to be the exclusive sponsor of the center's theatrical events. The company makes a payment of cash and products in the amount of $100,000 to Q, and in return, Q agrees to make a broadcast announcement thanking the company before each show and to provide $2,000 of advertising in the show's program (2% of $100,000 is $2,000). The announcement constitutes use or acknowledgment pursuant to section 513(i)(2). Because the value of the advertising does not exceed 2% of the total payment, the entire $100,000 is a qualified sponsorship payment under section 513(i), and $100,000 is treated as a contribution for purposes of section 509(a)(2)(A)(i).

Example 3. R, a charity, enters into a contract with a law firm to be the exclusive sponsor of the charity's outreach program. Instead of making a cash payment, the law firm agrees to perform $100,000 of legal services for the charity. In return, R agrees to acknowledge the law firm in all its informational materials. The total fair market value of the legal services, or $100,000, is a qualified sponsorship payment under section 513(i), but no amount is treated as a contribution under section 509(a)(2)(A)(i) because the contribution is of services.

* * * * * *

Par. 4. Section 1.512(a)–1 is amended by:

1. Revising the paragraph heading and introductory text for paragraph (e).

2. Redesignating the current *Example* in paragraph (e) as *Example 1* and revising the heading.

3. Adding *Example 2* to paragraph (e).

The revisions and additions read as follows:

§ 1.512(a)–1 Definition.

* * * * *

(e) *Examples*. This section is illustrated by the following examples:

Example 1. * * *

Example 2. (i) P, a manufacturer of photographic equipment, underwrites a photography exhibition organized by M, an art museum described in section 501(c)(3). In return for a payment of $100,000, M agrees that the exhibition catalog sold by M in connection with the exhibit will advertise P's product. The exhibition catalog will also include educational material, such as copies of photographs included in the exhibition, interviews with photographers, and an essay by the curator of M's department of photography. For purposes of this example, assume that none of the $100,000 is a qualified sponsorship payment within the meaning of section 513(i) and § 1.513–4, that M's advertising activity is regularly carried on, and that the entire amount of the payment is unrelated business taxable income to M. Expenses directly connected with generating the unrelated business taxable income (*i.e.*, direct advertising costs) total $25,000. Expenses directly connected with the preparation and publication of the exhibition catalog (other than direct advertising costs) total $110,000. M receives $60,000 of gross revenue from sales of the exhibition catalog. Expenses directly connected with the conduct of the exhibition total $500,000.

(ii) The computation of unrelated business taxable income is as follows:

(A) Unrelated trade or business (sale of advertising):			
	Income	$100,000	
	Directly-connected expenses	(25,000)	
	Subtotal	75,000	$75,000
(B) Exempt function (publication of exhibition catalog):			
	Income (from catalog sales)	60,000	
	Directly-connected expenses	(110,000)	
	Net exempt function income (loss)	(50,000)	(50,000)
	Unrelated business taxable income		25,000

(iii) Expenses related to publication of the exhibition catalog exceed revenues by $50,000. Because the unrelated business activity (the sale of advertising) exploits an exempt activity (the publication of the exhibition catalog), and because the publication of editorial material is an activity normally conducted by taxable entities that sell advertising, the net loss from the exempt publication activity is allowed as a deduction from unrelated business income under paragraph (d)(2) of this section. In contrast, the presentation of an exhibition is not an activity normally conducted by taxable entities engaged in advertising and publication activity for purposes of paragraph (d)(2) of this section. Consequently, the $500,000 cost of presenting the exhibition is not directly connected with the conduct of the unrelated advertising activity and does not have a proximate and primary relationship to that activity. Accordingly, M has unrelated business taxable income of $25,000.

* * * * *

Par. 5. Section 1.513–4 is added to read as follows:

§ 1.513–4 Certain sponsorship not unrelated trade or business.

(a) *In general*. Under section 513(i), the receipt of qualified sponsorship payments by an exempt organization which is subject to the tax imposed by section 511 does not constitute receipt of income from an unrelated trade or business.

(b) *Exception*. The provisions of this section do not apply with respect to payments made in connection with qualified convention and trade show activities. For rules governing qualified convention and trade show activity, see § 1.513–3. The provisions of this section also do not apply to income derived from the sale of advertising or acknowledgments in exempt organization periodicals. For this purpose, the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization. For this purpose, printed material includes material that is published electronically. For rules governing the sale of advertising in exempt organization periodicals, see § 1.512(a)–1(f).

(c) *Qualified sponsorship payment*—(1) *Definition*. The term *qualified sponsorship payment* means any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit. In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's exempt purpose. It is also irrelevant whether the sponsored activity is temporary or permanent. For purposes of this section, payment means the payment of money, transfer of property, or performance of services.

(2) *Substantial return benefit*—(i) *In general*. For purposes of this section, a *substantial return benefit* means any benefit other than a use or acknowledgment described in paragraph (c)(2)(iv) of this section, or disregarded benefits described in paragraph (c)(2)(ii) of this section.

(ii) *Certain benefits disregarded*. For purposes of paragraph (c)(2)(i) of this section, benefits are disregarded if the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than 2% of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2% of the amount of the payment, then (except as provided in paragraph (c)(2)(iv) of this section) the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit. Fair market value is determined as provided in paragraph (d)(1) of this section.

(iii) *Benefits defined*. For purposes of this section, benefits provided to the payor or persons designated by the payor may include:

(A) Advertising as defined in paragraph (c)(2)(v) of this section.

(B) Exclusive provider arrangements as defined in paragraph (c)(2)(vi)(B) of this section.

(C) Goods, facilities, services or other privileges.

(D) Exclusive or nonexclusive rights to use an intangible asset (*e.g.*, trademark, patent, logo, or designation) of the exempt organization.

(iv) *Use or acknowledgment*. For purposes of this section, a substantial return benefit does not include the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in connection with the activities of the exempt organization. Use or acknowledgment does not include advertising as described in paragraph (c)(2)(v) of this section, but may include the following: exclusive sponsorship arrangements; logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company; a list of the payor's locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services; and the payor's brand or trade names and product or service listings. Logos or slogans that are an established part of a payor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or remuneration, of a payor's product by the payor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor's product for purposes of this section and, thus, will not affect the determination of whether a payment is a qualified sponsorship payment.

(v) *Advertising*. For purposes of this section, the term *advertising* means any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product. A single message that contains both advertising and an acknowledgment is advertising. This section does not apply to activities conducted by a payor on its own. For example, if a payor purchases broadcast time from a television station to advertise its product during commercial breaks in a sponsored program, the exempt organization's activities are not thereby converted to advertising.

(vi) *Exclusivity arrangements*—(A) *Exclusive sponsor*. An arrangement that acknowledges the payor as the exclusive sponsor of an exempt organization's activity, or the exclusive sponsor representing a particular trade, business or industry, generally does not, by itself, result in a substantial return benefit. For example, if in exchange for a payment, an organization announces that its event is sponsored exclusively by the payor (and does not provide any advertising or other substantial return benefit to the payor), the payor has not received a substantial return benefit.

(B) *Exclusive provider*. An arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity generally results in a substantial return benefit. For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit.

(d) *Allocation of payment*—(1) *In general*. If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. However, if the exempt organization does not establish that the payment exceeds the fair market value of any substantial return benefit, then no portion of the payment constitutes a qualified sponsorship payment.

(i) *Treatment of payments other than qualified sponsorship payments*. The unrelated business income tax (UBIT) treatment of any payment (or portion thereof) that is not a qualified sponsorship payment is determined by application of sections 512, 513, and 514. For example, payments related to an exempt organization's providing facilities, services, or other privileges to the payor or persons designated by the payor, advertising, exclusive provider arrangements described in paragraph (c)(2)(vi)(B) of this section, a license to use intangible assets of the exempt organization, or other substantial return benefits, are evaluated separately in determining whether the exempt organization realizes unrelated business taxable income.

(ii) *Fair market value*. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement.

(iii) *Valuation date*. In general, the fair market value of the substantial return benefit is determined when the benefit is provided. However, if the parties enter into a binding, written sponsorship contract, the fair market value of any substantial return benefit provided pursuant to that contract is determined on the date the parties enter into the sponsorship contract. If the parties make a material change to a sponsorship contract, it is treated as a new sponsorship contract as of the date the material change is effective. A material change includes an extension or renewal of the contract, or a more than incidental change to any amount payable (or other consideration) pursuant to the contract.

(iv) *Examples*. The following examples illustrate the provisions of this section:

Example 1. On June 30, 2001, a national corporation and Z, a charitable organization, enter into a five-year binding, written contract effective for years 2002 through 2007. The contract provides that the corporation will make an annual payment of $5,000 to Z, and in return the corporation will receive no benefit other than advertising. On June 30, 2001, the fair market value of the advertising to be provided to the corporation in each year of the agreement is $75, which is less than the disregarded benefit amount provided for in paragraph (c)(2)(ii) of this section (2% of $5,000 is $100). In 2002, pursuant to the sponsorship contract, the corporation makes a payment to Z of $5,000, and receives the specified benefit (advertising). As of January 1, 2002, the fair market value of the advertising to be provided by Z each year has increased to $110. However, for purposes of this section, the fair market value of the advertising benefit is determined on June 30, 2001, the date the parties entered into the sponsorship contract. Therefore, the entire $5,000 payment received in 2002 is a qualified sponsorship payment.

Example 2. The facts are the same as *Example 1*, except that the contract provides for an initial payment by the corporation to Z of $5,000 in 2002, followed by annual payments of $1,000 during each of years 2003–2007. In 2003, pursuant to the sponsorship contract, the corporation makes a payment to Z of $1,000, and receives the specified advertising benefit. In 2003, the fair market value of the benefit provided ($75, as determined on June 30, 2001) exceeds 2% of the total payment received (2% of

$1,000 is $20). Therefore, only $925 of the $1,000 payment received in 2003 is a qualified sponsorship payment.

(2) *Anti-abuse provision*. To the extent necessary to prevent avoidance of the rule stated in paragraphs (d)(1) and (c)(2) of this section, where the exempt organization fails to make a reasonable and good faith valuation of any substantial return benefit, the Commissioner (or the Commissioner's delegate) may determine the portion of a payment allocable to such substantial return benefit and may treat two or more related payments as a single payment.

(e) *Special rules*—(1) *Written agreements*. The existence of a written sponsorship agreement does not, in itself, cause a payment to fail to be a qualified sponsorship payment. The terms of the agreement, not its existence or degree of detail, are relevant to the determination of whether a payment is a qualified sponsorship payment. Similarly, the terms of the agreement and not the title or responsibilities of the individuals negotiating the agreement determine whether a payment (or any portion thereof) made pursuant to the agreement is a qualified sponsorship payment.

(2) *Contingent payments*. The term *qualified sponsorship payment* does not include any payment the amount of which is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity. The fact that a payment is contingent upon sponsored events or activities actually being conducted does not, by itself, cause the payment to fail to be a qualified sponsorship payment.

(3) *Determining public support*. Qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or 509(a)(2). See §§ 1.509(a)–3(f)(1) and 1.170A–9(e)(6)(i). The fact that a payment is a qualified sponsorship payment that is treated as a contribution to the payee organization does not determine whether the payment is deductible by the payor under section 162 or 170.

(f) *Examples*. The provisions of this section are illustrated by the following examples. The tax treatment of any payment (or portion of a payment) that does not constitute a qualified sponsorship payment is governed by general UBIT principles. In these examples, the recipients of the payments at issue are section 501(c) organizations. The expectations or arrangements of the parties are those specifically indicated in the example. The examples are as follows:

Example 1. M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgment of the sponsorship. The drinks, refreshments and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 2. N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation's support by using the corporate name and established logo in materials publicizing the exhibition, which include banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2% of the total payment. N's use of the corporate name and logo in connection with the exhibition constitutes acknowledgment of the sponsorship. However, because the fair market value of the dinner exceeds 2% of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.

Example 3. O coordinates sports tournaments for local charities. An auto manufacturer agrees to underwrite the expenses of the tournaments. O recognizes the auto manufacturer by including the manufacturer's name and established logo in the title of each tournament as well as on signs, scoreboards and other printed material. The auto manufacturer receives complimentary admission passes and pro-am playing spots for each tournament that have a combined fair market value in excess of 2% of the total payment. Additionally, O displays the latest models of the manufacturer's premier luxury cars at each tournament. O's use of the manufacturer's name and logo and display of cars in the tournament area constitute acknowledgment of the sponsorship. However, the admission passes and pro-am playing spots are a substantial return benefit. Only that portion of the payment, if any, that O can demonstrate exceeds the fair market value of the admission passes and pro-am playing spots is a qualified sponsorship payment.

Example 4. P conducts an annual college football bowl game. P sells to commercial broadcasters the right to broadcast the bowl game on television and radio. A major corporation agrees to be the exclusive sponsor of the bowl game. The detailed contract between P and the corporation provides that in exchange for a $1,000,000 payment, the name of the bowl game will include the name of the corporation. In addition, the contract provides that the corporation's name and established logo will appear on player's helmets and uniforms, on the scoreboard and stadium signs, on the playing field, on cups used to serve drinks at the game, and on all related printed material distributed in connection with the game. P also agrees to give the corporation a block of game passes for its employees and to provide advertising in the bowl game program book. The fair market value of the passes is $6,000, and the fair market value of the program advertising is $10,000. The agreement is contingent upon the game being broadcast on television and radio, but the amount of the payment is not contingent upon the number of people attending the game or the television ratings. The contract provides that television cameras will focus on the corporation's name and logo on the field at certain intervals during the game. P's use of the corporation's name and logo in connection with the bowl game constitutes acknowledgment of the sponsorship. The exclusive sponsorship arrangement is not a substantial return benefit. Because the fair market value of the game passes and program advertising ($16,000) does not exceed 2% of the total payment (2% of $1,000,000 is $20,000), these benefits are disregarded and the entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 5. Q organizes an amateur sports team. A major pizza chain gives uniforms to players on Q's team, and also pays some of the team's operational expenses. The uniforms bear the name and established logo of the pizza chain. During the final tournament series, Q distributes free of charge souvenir flags bearing Q's name to employees of the pizza chain who come out to support the team. The flags are valued at less than 2% of the combined fair market value of the uniforms and operational expenses paid. Q's use of the name and logo of the pizza chain in connection with the tournament constitutes acknowledgment of the sponsorship. Because the fair market value of the flags does not exceed 2% of the total payment, the entire amount of the funding and supplied uniforms are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 6. R is a liberal arts college. A soft drink manufacturer enters into a binding, written contract with R that provides for a large payment to be made to the college's English department in exchange for R agreeing to name a writing competition after the soft drink manufacturer. The contract also provides that R will allow the soft drink manufacturer to be the exclusive provider of all soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds 2% of the total payment. R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.

Example 7. S is a noncommercial broadcast station that airs a program funded by a local music store. In exchange for the funding, S broadcasts the following message: "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555–1234. This station is proud to have the Music Shop as a sponsor." Because this single broadcast message contains both advertising and an acknowledgment, the entire message is advertising. The fair market value of the advertising exceeds 2% of the total payment. Thus, the advertising is a substantial return benefit. Unless S establishes that the amount of the payment exceeds the fair market value of the advertising, none of the payment is a qualified sponsorship payment.

Example 8. T, a symphony orchestra, performs a series of concerts. A program guide that contains notes on guest conductors and other information concerning the evening's program is distributed by T at each concert. The Music Shop makes a $1,000 payment to T in support of the concert series. As a supporter of the event, the Music Shop receives complimentary concert tickets with a fair market value of $85, and is recognized in the program guide and on a poster in the lobby of the concert hall. The lobby poster states that, "The T concert is sponsored by the Music Shop, located at 123 Main Street, telephone number 555–1234." The program guide contains the same information and also states, "Visit the Music Shop today for the finest selection of music CDs and cassette tapes." The fair market value of the advertisement in the program guide is $15. T's use of the Music Shop's name, address, and telephone number in the lobby poster constitutes acknowledgment of the sponsorship. However, the combined fair market value of the advertisement in the program guide and complimentary tickets is $100 ($15 + $85), which exceeds 2% of the total payment (2% of $1,000 is $20). The fair market value of the advertising and complimentary tickets, therefore, constitutes a substantial return benefit and only that portion of the payment, or $900, that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment.

Example 9. U, a national charity dedicated to promoting health, organizes a campaign to inform the public about potential cures to fight a serious disease. As part of the campaign, U sends representatives to community health fairs around the country to answer questions about the disease and inform the public about recent developments in the search for a cure. A pharmaceutical company makes a payment to U to fund U's booth at a health fair. U places a sign in the booth displaying the pharmaceutical company's name and slogan, "Better Research, Better Health," which is an established part of the company's identity. In addition, U grants the pharmaceutical company a license to use U's logo in marketing its products to health care providers around the country. The fair market value of the license exceeds 2% of the total payment received from the company. U's display of the pharmaceutical company's name and slogan constitutes acknowledgment of the sponsorship. However, the license granted to the pharmaceutical company to use U's logo is a substantial return benefit. Only that portion of the payment, if any, that U can demonstrate exceeds the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

Example 10. V, a trade association, publishes a monthly scientific magazine for its members containing information about current issues and developments in the field. A textbook publisher makes a large payment to V to have its name displayed on the inside cover of the magazine each month. Because the monthly magazine is a periodical within the meaning of paragraph (b) of this section, the section 513(i) safe harbor does not apply. See § 1.512(a)–1(f).

Example 11. W, a symphony orchestra, maintains a website containing pertinent information and its performance schedule. The Music Shop makes a payment to W to fund a concert series, and W posts a list of its sponsors on its website, including the Music Shop's name and Internet address. W's website does not promote the Music Shop or advertise its merchandise. The Music Shop's Internet address appears as a hyperlink from W's website to the Music Shop's website. W's posting of the Music Shop's name and Internet address on its website constitutes acknowledgment of the sponsorship. The entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 12. X, a health-based charity, sponsors a year-long initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X's website. X's website contains a hyperlink to the pharmaceutical company's website. On the pharmaceutical company's website, the statement appears, "X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition." X reviewed the endorsement before it was posted on the pharmaceutical company's website and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company's website is a qualified sponsorship payment.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 12, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 24, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 25, 2002, 67 F.R. 20433)

Section 1012.—Basis of Property—Cost

26 CFR 1.1012–1: Basis of property.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

Section 6050S.— Returns Relating to Higher Education Tuition and Related Expenses

26 CFR 1.6050S–2T: Electronic furnishing of information statements for qualified tuition and related expenses (temporary).

T.D. 8992

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602

Information Reporting for Payments of Interest on Qualified Education Loans; Magnetic Media Filing Requirements for Information Returns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the information reporting requirements under section 6050S for payments of interest on qualified education loans, including the filing of information returns on magnetic media. The final regulations reflect changes to the law made by the Taxpayer Relief Act of 1997. The regulations provide guidance to payees receiving interest payments on qualified education loans.

DATES: *Effective date*: These regulations are effective April 29, 2002.

Applicability date: For date of applicability, see § 1.6050S–3(g).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622–4910; and concerning the magnetic media filing specifications, waivers for filing on magnetic media, and extensions of time, contact the Internal Revenue Service, Martinsburg Computing Center, (304) 263–8700 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1678. Responses to this collection of information are mandatory.

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

The estimated burden for the reporting in these regulations is reflected in the burden for Form 1098–E.

Estimated total annual reporting burden for 2000 for Form 1098–E: 483,098 hours.

Estimated number of responses for 2000 for Form 1098–E: 9,661,965.

Estimated average annual burden hours per response for Form 1098–E: 3 minutes.

Comments concerning the accuracy of this burden and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to information reporting requirements under section 6050S. The Taxpayer Relief Act of 1997 (Public Law 105–34 (111 Stat. 788) (TRA '97)) added section 221 of the Internal Revenue Code (Code) to allow certain taxpayers who pay interest on qualified education loans to claim a Federal income tax deduction for their interest payments. In general, as enacted by TRA '97, a deduction is allowed for interest payments made during the first 60 months in which interest payments are required on a qualified education loan. However, no interest deduction is allowed for any interest paid before January 1, 1998. On January 21, 1999, the IRS issued proposed regulations (REG–116826–97, 1999–1 C.B. 701) under section 221. See 64 FR 3257 (1999). Section 221 was amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107–16 (115 Stat. 38)) to eliminate the limitation on the number of months during which interest paid on a qualified education loan is deductible, effective for interest paid after December 31, 2001, and to allow a deduction for voluntary payments of interest.

TRA '97 also added section 25A of the Code to provide the Hope Scholarship Credit and the Lifetime Learning Credit (education tax credit). In general, the education tax credit allows certain taxpayers who pay qualified tuition and related expenses to an eligible educational institution to claim a nonrefundable credit against their Federal income tax liability. On January 6, 1999, the IRS issued proposed regulations (REG–106388–98, 1999–1 C.B. 756) under section 25A. See 64 FR 794 (1999).

In addition, TRA '97 added section 6050S of the Code. Section 6050S was amended by the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206 (112 Stat. 685) (RRA '98)) and Public Law 107–131 (115 Stat. 2410). In general, section 6050S requires certain payees who receive payments of interest on one or more qualified education loans to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any interest deduction allowable under section 221. In addition, section 6050S requires eligible educational institutions to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any education tax credit allowable under section 25A (as well as other tax benefits for higher education expenses). See H.R. Conf. Rept. No. 599, 105th Cong., 2d Sess., pp. 319–320 (1998). Similarly, section 6050S requires any person engaged in a trade or business of making payments to any individual under an insurance agreement as reimbursements or refunds of qualified tuition and related expenses to file information returns and to furnish written information statements.

Section 6050S(b) provides that the information return filed by payees who receive payments of interest on qualified education loans must contain: (1) the name, address, and taxpayer identification number (TIN) of the individual with respect to whom payments of interest on qualified education loans were received; (2) the aggregate amount of interest received for the calendar year from such individual; and (3) such other information as the Secretary may prescribe.

The IRS has published several notices describing the information reporting requirements for payees who receive interest on qualified education loans during the years 1998, 1999, 2000, and 2001. See Notice 98–7 (1998–1 C.B. 339), Notice 98–54 (1998–2 C.B. 641), Notice 99–37 (1999–2 C.B. 124), and Notice 2000–62 (2000–2 C.B. 587).

A notice of proposed rulemaking under section 6050S (REG–105316–98, 2000–2 C.B. 98) was published in the **Federal Register** (65 FR 37728) on June 16, 2000, addressing the information reporting requirements for eligible educational institutions and insurers and payees who receive interest on qualified education loans. A public hearing was held on the proposed regulations on February 13, 2001. The IRS received written and electronic comments responding to the notice of proposed rulemaking.

The IRS and the Treasury Department have determined that the proposed regulations in § 1.6050S–1 addressing the information reporting requirements for eligible educational institutions and insurers should be withdrawn and that new proposed regulations should be issued. The IRS will issue proposed regulations in § 1.6050S–1 in a separate document. The proposed regulations in § 1.6050S–2 addressing the information reporting requirements for payees who receive payments of interest on qualified education loans are adopted as amended by this Treasury decision and redesignated as § 1.6050S–3. The comments received in connection with these regulations and the revisions are discussed in the "Explanation of Provisions and Summary of Comments" of this preamble.

Temporary regulations (66 FR 10191) and a notice of proposed rulemaking by cross reference (REG–107186–00, 2001–1 C.B. 973) (66 FR 10247) under section 6050S were published in the **Federal Register** on February 14, 2001. Those regulations allow eligible educational institutions and payees who receive interest on qualified education loans to furnish information statements electronically to students and borrowers, respectively, if certain requirements are met. The temporary regulations for eligible educational institutions were designated as § 1.6050S–1T, and the temporary regulations for payees were designated as § 1.6050S–2T. The IRS and the Treasury Department have determined that those regulations should be finalized in a separate document. However, this Treasury decision redesignates § 1.6050S–1T and § 1.6050S–2T as § 1.6050S–2T and § 1.6050S–4T, respectively.

Explanation of Provisions and Summary of Comments

1. Information Reporting for Payments of Interest on Qualified Education Loans

The proposed regulations require any person engaged in a trade or business that receives from any payor interest of $600 or more for any calendar year on one or more qualified education loans (as defined in section 221(e)(1) and the regulations thereunder) (a payee) to file a Form 1098–E, *Student Loan Interest Statement*, with the IRS. Under the proposed regulations, a payee must report the name, address, and taxpayer identification number (TIN) of the payee; the name, address, and TIN of the payor; and the aggregate amount of interest received during the calendar year from the payor. The final regulations retain these rules. As explained in the preamble to the proposed regulations, a payee may be the lender, the holder of the loan, or the loan servicer.

Consistent with TRA '97, the proposed regulations provide that a payee is required to report interest payments received on a qualified education loan during only the first 60 months in which interest payments are required on the loan. The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the limitation on the number of months during which interest paid on a qualified education loan is deductible, effective for interest paid after December 31, 2001. Therefore, the final regulations eliminate the 60-month reporting period, so that payees must continue to report annually interest payments on qualified education loans.

A. *Section 221 comments*

The proposed regulations provide that, in determining the aggregate amount of interest payments to be reported by a payee, the term *interest* includes stated interest, loan origination fees (other than any fees for services), and capitalized interest as described in the regulations under section 221. Several commentators requested that other fees, such as insurance, be treated as deductible interest for purposes of section 221. In addition, several commentators requested clarification of, or changes to, the manner in which payments are allocated to interest, the definition of *qualified education loans*, and the ability to estimate capitalized interest. These comments were not considered in these regulations, which address only the information reporting requirements for interest payments on qualified education loans under section 221, but the comments will be considered in finalizing the regulations under section 221.

B. *Reporting of interest received or collected by one or more persons*

Section 6050S(f) requires that, in the case of any person who receives any amount on behalf of another person, only the first person receiving the amount is required to comply with the information reporting requirements. Based on section 6050S(f), the proposed regulations provide that if a payee contracts with another person to receive or collect interest payments on a qualified education loan on its behalf, the other person must comply with the information reporting requirements. Commentators requested clarification of how this rule would apply if a payee contracts with multiple parties, such as a billing service and a collection agent. Other commentators requested clarification of the rule for noncontractual arrangements and how the rule would apply if the person receiving the payments does not ordinarily possess the payor information required to file information returns (*e.g.*, a lock-box agent, a bankruptcy trustee, or a collection agency). The commentators suggested that the regulations provide that if a person collects or receives payments on a qualified loan on behalf of another person (whether or not a formal contract exists), the person collecting or receiving the payments must satisfy the reporting requirements, unless the other person does not possess the information needed to comply with the reporting requirements. This recommendation is consistent with the provisions of section 6050H and the regulations thereunder; therefore, the final regulations adopt this recommendation.

C. *Forms 1098–E filed by third-party*

Several commentators requested that the final regulations permit a payee to contract with a third party to file Forms 1098–E, *Student Loan Interest Statement*, and to furnish the information statements. The general instructions to Form 1099 and Form 1098 allow a filing agent if certain requirements are met. Therefore, the final regulations do not need to adopt this recommendation.

D. *Information statement*

Several commentators requested that the final regulations eliminate the requirement that a payee furnish certain instructions to a payor with the information statement. The commentators explained that the instructional language implies that the payee is able to provide tax assistance. The instructions that a payee is required to furnish with the information statement alert the payor to the limitations on the deductibility of reported interest. In addition, the instructions clearly state that the payor should refer to the IRS forms and publications for information regarding the deductibility of reported interest. Therefore, the final regulations do not eliminate the required instructions; however, the regulations clarify that the payor should refer to the IRS forms and publications, and not the payee, for tax information.

The proposed regulations provide that the information statement must include the name, address, and phone number of the individual who is the information contact for the payee that filed the Form 1098–E. It is often not feasible for payees to identify a specific individual as the information contact. Therefore, the final regulations provide that the information statement must include the name, address, and phone number of an office or department of the payee as the information contact.

E. *Payment adjustments after returns filed*

Other commentators requested that the final regulations provide specific rules for reporting interest payment adjustments made after information returns have been filed with the IRS. The commentators stated that requiring reporting of adjustments to interest previously reported would be overly burdensome. The final regulations do not need to include specific rules because additional interest payments received in a subsequent year that relate to interest payments reported in a prior year are reportable in the year of receipt. Further, a payee is not required to report reimbursements or refunds of interest payments previously reported. However, a payee should file corrected information returns to report interest payments that were incorrectly reported in a prior year.

F. *Effective date of regulations and continuation of Notice 98–7 for the calendar year 2002*

The proposed regulations provide that the regulations will apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2001. Several comments were received on the proposed effective date. Several commentators recommended that the final regulations apply to new loans made on or after January 1 of the year that is 24 months after publication of the final regulations and that loans made before that date remain subject to the requirements in Notice 98–7, as modified. Other comments requested a period of at least 12 months after publication of final regulations to make programming changes to implement required reporting with respect to loan origination fees and capitalized interest.

Further comments requested that the reporting requirements in Notice 98–7, as modified, continue for information returns required to be filed, and information statements required to be furnished, for interest payments received during calendar year 2002 (for which the returns and statements are required to be filed and furnished in 2003). In general, the final regulations do not impose any significant reporting requirement beyond the reporting currently required by Notice 98–7, as modified, and Form 1098–E. However, in response to comments, the IRS and the Treasury Department extend Notice 98–7, as modified, for the calendar year 2002. Therefore, the final regulations apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003 (for interest payments received during calendar year 2003). In addition, in order to provide additional time for payees to implement reporting of loan origination fees and capitalized interest, the final regulations provide that a payee is not required to report payments of such amounts as interest for qualified education loans made before January 1, 2004.

2. *Requirement to File Information Returns on Magnetic Media*

The final regulations amend the regulations under section 6011(e) to require payees who are required to file 250 or more Forms 1098–E to file on magnetic media.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. A final regulatory flexibility analysis has been prepared for the collection of information in this Treasury decision. This analysis is set forth in this preamble under the heading "Final Regulatory Flexibility Analysis." Pursuant to section 7805(f), the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Final Regulatory Flexibility Analysis

The collection of information contained in § 1.6050S–3 is needed to assist the IRS and taxpayers in determining the amount of any interest deduction allowable under section 221. The objectives of these regulations are to provide uniform, practicable, and administrable rules under section 6050S. The types of small entities to which the regulations may apply are certain payees (*e.g.*, a lender, a holder of the loan, or a loan servicer) who receive interest payments of $600 or more on qualified education loans.

There are no known Federal rules that duplicate, overlap, or conflict with these regulations. The regulations are considered to have the least economic impact on small entities of all alternatives considered.

Moreover, the regulations requiring filing Forms 1098–E on magnetic media impose no additional reporting or recordkeeping and only prescribe the method of filing information returns that are already required to be filed. Further, these regulations are consistent with the statutory requirement that a payee is not required to file Forms 1098–E on magnetic media unless required to file at least 250 or more returns during the year. Finally, the economic impact caused by requiring Forms 1098–E on magnetic media should be minimal because most payee's operations are computerized. Even if their operations are not computerized, the incremental cost of magnetic media reporting should be minimal in most cases because of the availability of computer service bureaus. In addition, the existing regulations under section 6011(e) provide that the IRS may waive the magnetic media filing requirements on a showing of hardship. The waiver authority will be exercised so as not to unduly burden payees lacking both the necessary data processing facilities and access at a reasonable cost to computer service bureaus.

Drafting Information

The principal author of the regulations is Donna Welch, Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

PART 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "Section 1.6050S–1T" and by adding entries in numerical order to read in part as follows:

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

Section 1.6050S–3 also issued under 26 U.S.C. 6050S(g).

Section 1.6050S–4T also issued under 26 U.S.C. 6050S(g). * * *

Par. 2. Sections 1.6050–1T and 1.6050S–2T are redesignated as §§ 1.6050S–2T and 1.6050S–4T, respectively, and amended by revising the section headings to read as follows:

§ 1.6050S–2T Electronic furnishing of information statements for qualified tuition and related expenses (temporary).

* * * * *

§ 1.6050S–4T Electronic furnishing of information statements for payments of interest on qualified education loans (temporary).

* * * * *

Par. 3. Sections 1.6050S–0 and 1.6050S–3 are added to read as follows:

§ 1.6050S–0 Table of contents

This section lists captions contained in section 6050S.

§ 1.6050S–2T Electronic furnishing of information statements for qualified tuition and related expenses.

§ 1.6050S–3 Information reporting for payments of interest on qualified education loans.

§ 1.6050S–4T Electronic furnishing of information statements for payments of interest on qualified education loans.

§ 1.6050S–3 Information reporting for payments of interest on qualified education loans.

(a) *Information reporting requirement in general.* Except as otherwise provided in this section, any person engaged in a trade or business that, in the course of that trade or business, receives from any payor (as defined in paragraph (b)(2) of this section) interest payments that aggregate $600 or more for any calendar year on one or more qualified education loans (as defined in section 221(e)(1) and the regulations thereunder)(a payee) must—

(1) File an information return, as described in paragraph (c) of this section, with the Internal Revenue Service with respect to the payor; and

(2) Furnish a statement, as described in paragraph (d) of this section, to the payor.

(b) *Definitions*. The following definitions apply for purposes of this section:

(1) *Interest*. *Interest* includes stated interest, loan origination fees (other than fees for services), and capitalized interest as described in the regulations under section 221. See paragraph (e)(1) of this section for a special transitional rule relating to reporting of loan origination fees and capitalized interest.

(2) *Payor*. *Payor* means the individual who is carried on the books and records of the payee as the borrower on a qualified education loan. If there are multiple borrowers, the principal borrower on the payee's books and records is treated as the payor for purposes of section 6050S and this section.

(c) *Requirement to file return*—(1) *Form of return*. A payee must file an information return for the payor on Form 1098–E, *Student Loan Interest Statement*. A payee may use a substitute for Form 1098–E if the substitute form complies with the applicable revenue procedures relating to substitute forms.

(2) *Information included on return*. A payee must include on Form 1098–E—

(i) The name, address, and taxpayer identification number (TIN)(as defined in section 7701(a)(41)) of the payee;

(ii) The name, address, and TIN of the payor;

(iii) The aggregate amount of interest payments received during the calendar year from the payor; and

(iv) Any other information required by Form 1098–E and its instructions.

(3) *Time and place for filing return*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, the Form 1098–E must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which interest payments were received. A payee must file Form 1098–E with the Internal Revenue Service according to the instructions to Form 1098–E.

(ii) *Extensions of time*. The Internal Revenue Service may grant a payee an extension of time to file returns required in this section upon a showing of good cause. See the instructions to Form 1098–E and applicable revenue procedures for rules relating to extensions of time to file.

(4) *Use of magnetic media*. See section 6011(e) and § 301.6011–2 of this chapter for rules relating to the requirement to file Forms 1098–E on magnetic media.

(d) *Requirement to furnish statement*—(1) *In general*. A payee must furnish a statement to each payor for whom it is required to file a Form 1098–E. The statement must include—

(i) The information required under paragraph (c)(2) of this section;

(ii) A legend that identifies the statement as important tax information that is being furnished to the Internal Revenue Service;

(iii) Instructions that—

(A) State that, under section 221 and the regulations thereunder, the payor may not be able to deduct the full amount of interest reported on the statement;

(B) In the case of qualified education loans made before January 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;

(C) State that the payor should refer to relevant Internal Revenue Service forms and publications, and should not refer to the payee, for explanations relating to the eligibility requirements for, and calculation of, any allowable deduction for interest paid on a qualified education loan; and

(D) Include the name, address, and phone number of the office or department of the payee that is the information contact for the payee that filed the Form 1098–E.

(2) *Time and manner for furnishing statement*—(i) *In general*. Except as provided in paragraph (d)(2)(ii) of this section, a payee must furnish the statement described in paragraph (d)(1) of this section to the payor on or before January 31 of the year following the calendar year in which payments of interest on a qualified education loan were received. If mailed, the statement must be sent to the payor's last known address. If furnished electronically, the statement must be furnished in accordance with the applicable regulations.

(ii) *Extensions of time*. The Internal Revenue Service may grant a payee an extension of time to furnish statements required in this section upon a showing of good cause. See the instructions to Form 1098–E and applicable revenue procedures for rules relating to extensions of time to furnish statements.

(3) *Copy of Form 1098–E*. A payee may satisfy the requirement of this paragraph (d) by furnishing either a copy of Form 1098–E and its instructions or another document that contains all the information filed with the Internal Revenue Service and the information required by paragraph (d)(1) of this section if the document complies with applicable revenue procedures relating to substitute statements.

(e) *Special rules*—(1) *Transitional rule for reporting of loan origination fees and capitalized interest*. For qualified education loans made before January 1, 2004, a payee is not required to report payments of loan origination fees and capitalized interest as interest under section 6050S and this section.

(2) *Qualified education loan certification*. If a loan is not subsidized, guaranteed, financed, or is not otherwise treated as a student loan under a program of the Federal, state, or local government or an eligible educational institution, a payee must request a certification from the payor that the loan will be used solely to pay for qualified higher education expenses. A payee may use Form W–9S, *Request for Student's or Borrower's Social Security Number and Certification*, to obtain the certification. A payee may establish an electronic system for payors to submit Forms W–9S electronically as described in applicable forms and instructions. A payee may also develop a separate form to obtain the payor certification or may incorporate the certification into other forms customarily used by the payee, such as loan applications, provided

the certification is clearly set forth. If the certification is not received, the loan is not a qualified education loan for purposes of section 6050S and this section.

(3) *Payments of interest received or collected by one or more persons*—(i) *In general*. Except as otherwise provided in paragraph (e)(3)(ii) of this section, if a person collects or receives payments of interest on a qualified education loan on behalf of another person (*e.g.*, a lender), the person collecting or receiving the interest must satisfy the information reporting requirements of this section. In this case, the reporting requirements do not apply to the transfer of interest to the other person.

(ii) *Exception*. If the person collecting or receiving payments of interest on a qualified education loan on behalf of another person (*e.g.*, a lender) does not possess the information needed to comply with the information reporting requirements of this section, the other person must satisfy the information reporting requirements of this section.

(4) *Reporting by foreign persons*. A payee that is not a United States person (as defined in section 7701(a)(30)) must report payments of interest it receives on a qualified education loan only if it receives the payment—

(i) At a location in the United States; or

(ii) At a location outside the United States if the payee is—

(A) A controlled foreign corporation (within the meaning of section 957(a)); or

(B) A person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of the taxable year preceding the taxable year in which interest payments were received (or for such part of the period as the person was in existence), was effectively connected with the conduct of a trade or business within the United States.

(5) *Governmental units*. A governmental unit, or an agency or instrumentality of a governmental unit, that receives from any payor interest payments that aggregate $600 or more for any calendar year on one or more qualified education loans is a payee, without regard to the requirement of paragraph (a) of this section that the interest be received in the course of a trade or business.

(f) *Penalty provisions*—(1) *Failure to file correct returns*. The section 6721 penalty may apply to a payee that fails to file information returns required by section 6050S and this section on or before the required filing date; that fails to include all of the required information on the return; or that includes incorrect information on the return. See section 6721, and the regulations thereunder, for rules relating to penalties for failure to file correct returns. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(2) *Failure to furnish correct information statements*. The section 6722 penalty may apply to a payee that fails to furnish statements required by section 6050S and this section on or before the prescribed date; that fails to include all the required information on the statement; or that includes incorrect information on the statement. See section 6722, and the regulations thereunder, for rules relating to penalties for failure to furnish correct statements. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(3) *Waiver of penalties for failures to include a correct TIN*—(i) *In general*. In the case of a failure to include a correct TIN on Form 1098–E or a related information statement, penalties may be waived if the failure is due to reasonable cause. Reasonable cause may be established if the failure arose from events beyond the payee's control, such as a failure of the payor to furnish a correct TIN. However, the payee must establish that it acted in a responsible manner both before and after the failure.

(ii) *Acting in a responsible manner*. A payee must request the TIN of each payor if it does not already have a record of the payor's correct TIN. If the payee does not have a record of the payor's correct TIN, then it must solicit the TIN in the manner described in paragraph (f)(3)(iii) of this section on or before December 31 of each year during which it receives payments of interest. If a payor refuses to provide his or her TIN upon request, the payee must file the return and furnish the statement required by this section without the payor's TIN, but with all other required information. The specific solicitation requirements of paragraph (f)(3)(iii) of this section apply in lieu of the solicitation requirements of § 301.6724–1(e) and (f) of this chapter for the purpose of determining whether a payee acted in a responsible manner in attempting to obtain a correct TIN. A payee that complies with the requirements of this paragraph (f)(3) will be considered to have acted in a responsible manner within the meaning of § 301.6724–1(d) of this chapter with respect to any failure to include the correct TIN of a payor on a return or statement required by section 6050S and this section.

(iii) *Manner of soliciting TIN*. A payee must request the payor's TIN in writing and must clearly notify the payor that the law requires the payor to furnish a TIN so that it may be included on an information return filed by the payee. A request for a TIN made on Form W–9S, *Request for Student's or Borrower's Social Security Number and Certification*, satisfies the requirements of this paragraph (f)(3)(iii). A payee may establish a system for payors to submit Forms W–9S electronically as described in applicable forms and instructions. A payee may also develop a separate form to request the payor's TIN or incorporate the request into other forms customarily used by the payee, such as loan applications.

(4) *Failure to furnish TIN*. The section 6723 penalty may apply to any payor who is required (but fails) to furnish his or her TIN to a payee. See section 6723, and the regulations thereunder, for rules relating to the penalty for failure to furnish a TIN.

(g) *Effective date*. The rules in this section apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Par. 5. Section 301.6011–2 is amended by:

1. Revising the first sentence of paragraph (b)(1).

2. Revising paragraph (g)(1).

3. Adding paragraph (g)(3).

The revisions and additions read as follows:

§ 301.6011–2 Required use of magnetic media.

* * * * *

(b) *Returns required on magnetic media*. (1) If the use of Forms 1042–S, 1098, 1098–E, 1099 series, 5498, 8027, W–2G, or other form treated as a form specified in this paragraph (b)(1) is required by the applicable regulations or revenue procedures for the purpose of making an information return, the information required by the form must be submitted on magnetic media, except as otherwise provided in paragraph (c) of this section. * * *

* * * * *

(g) *Effective dates*. (1) Except as otherwise provided in paragraph (g)(2) or (3) of this section, this section applies to returns required to be filed after December 31, 1986.

* * * * *

(3) This section applies to returns on Form 1098–E required to be filed after December 31, 2003.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In § 602.101, paragraph (b) is amended by removing the entry for "1.6050S–1T", and adding two new entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.6050S–3	1545–1678
1.6050S–4T	1545–1729
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 8, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 26, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 29, 2002, 67 F.R. 20901)

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002–32

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73 (1988–2 C.B. 383) provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for April 2002 is 5.68 percent. Pursuant to Notice 2002–26 (2002–15 I.R.B. 743), the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
May	2002	5.69	5.12 to 6.25	5.12 to 6.82

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

Suspension of Requirement to File Form 8390 (*Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809)*

Notice 2002–33

Section 809 of the Internal Revenue Code reduces the policyholder dividends that a mutual life insurance company is permitted to deduct under section 808. Each year, the Internal Revenue Service publishes the differential earnings rate (DER) and the recomputed differential earnings rate (RDER) to be used in computing the amount of the reduction. The DER and RDER are determined by the Service on the basis of information reported by mutual life insurance companies and the 50 largest stock life insurance companies (as determined by the Service) on Form 8390, *Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809*.

The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107–147, § 611, amended section 809 of the Code by adding new paragraph (j). As amended, section 809(j) provides that the DER shall be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003.

As a result of this amendment to section 809, the Service will not be computing the DER and RDER for 2001, 2002, or 2003.[*] The determination of the 50 largest stock companies, however, will be made for those years.

The suspension of section 809 by section 809(j) expires in 2004. Accordingly, life insurance companies will not be required to file Form 8390 in either 2002 or 2003.

[*]Notice 2002–19 (2002–10 I.R.B. 619) provided that the tentative DER for 2001 and RDER for 2000 are zero.

The Service will be required to compute a 2004 DER and RDER using prior year income information from both stock and mutual life insurance companies. Therefore, it is expected that the requirement that companies file Form 8390 will be reinstated in 2004. Mutual life insurance companies will be required to file a Form 8390 with respect to calendar years 2002 and 2003. Any stock life insurance company that is determined to be one of the 50 largest stock life insurance companies during 2001, 2002, or 2003 will be required to file a Form 8390 with respect to that year. All life insurance companies that may be required to report 2001, 2002, or 2003 information are obligated to retain the records necessary to report the appropriate information in 2004.

Life insurance companies that will be required to file a Form 8390 with respect to calendar years 2001 or 2002 will be required to file such form no later than July 1, 2004. Life insurance companies that will be required to file a Form 8390 with respect to calendar year 2003 will be required to file such form no later than October 1, 2004.

When filing Form 1120–L (*U.S. Life Insurance Company Income Tax Return*) for 2001, mutual life insurance companies should treat the DER as zero for purposes of computing the differential earnings amount in Schedule C (*Differential Earnings Amount*). Appropriate changes will be made to Form 1120–L for 2002.

For 2004 and years thereafter, the Service will issue additional guidance regarding the filing of Form 8390 by life insurance companies as needed.

Comments are requested on the implementation of section 809(j), the requirement that information with respect to 2001 and 2002 and information with respect to 2003 be filed separately, and any required changes to Form 1120–L (such as temporarily eliminating Schedule C). Comments should be sent to CC:ITA:RU (Notice 2002–33), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (Notice 2002–33), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. In the alternative, e-mail comments to *Notice.Comments@irscounsel.treas.gov*.

DRAFTING INFORMATION

The principal author of this notice is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. Hossofsky at 202–622–3477 (not a toll-free call).

IRS Announces Voluntary Compliance Program to Promote Disclosure by Political Organizations

Notice 2002–34

The Internal Revenue Service (IRS) announces a voluntary compliance program to promote disclosure by political organizations described in § 527 of the Internal Revenue Code (political organizations) that file certain forms by **July 15, 2002**.

BACKGROUND

On July 1, 2000, Pub. L. 106–230 was enacted, imposing new reporting and disclosure requirements on political organizations in connection with their tax-exempt status. The IRS is aware that there is a great deal of confusion concerning the new filing requirements. Because of this confusion, many political organizations have either failed to file or need to correct previously filed forms. The IRS believes that implementing this voluntary compliance program for these political organizations is most likely to achieve the congressional goal of maximum disclosure and is in the best interest of sound tax administration.

FILING REQUIREMENTS

The law generally requires a tax-exempt political organization to file:

- an initial notice of status on Form 8871,
- periodic reports of contributions and expenditures on Form 8872,
- annual information returns on Form 990 or Form 990–EZ, and
- annual income tax returns on Form 1120–POL.

See Rev. Rul. 2000–49 (2000–2 C.B. 430), and the attachment below for more information on the basic filing requirements. Forms may be downloaded from the IRS Web site at *www.irs.gov*. The IRS Web site also describes filing requirements at *www.irs.gov/polorgs*. To obtain assistance from the IRS, please call **877–829–5500** (a toll-free call).

VOLUNTARY COMPLIANCE PROGRAM

The IRS will not assert any tax, penalty or interest that arises solely because a political organization failed to file a form or filed an incorrect form, **if** the form is filed or corrected by **July 15, 2002**. This voluntary compliance program applies with respect to the following forms:

- Any Form 8871, *Political Organization Notice of 527 Status*, due on or before July 15, 2002,
- Any Form 8872, *Report of Contributions and Expenditures*, due on or before July 15, 2002,
- Any Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations*, due on or before July 15, 2002, including any applicable extensions,
- Any Form 990, *Return of Organization Exempt from Income Tax*, or Form 990–EZ, *Short Form Return of Organization Exempt from Income Tax*, due on or before July 15, 2002, including any applicable extensions.

If a political organization does not completely report its contributions and expenditures on all applicable Forms 8872 filed by July 15, 2002, it remains liable for the amount due under § 527(j)(1) on the unreported amounts. For any form described above that is filed or corrected **after** July 15, 2002, any applicable taxes, penalties and interest will be due from the original due date. In addition, this voluntary compliance program does not apply to any Form 1120–POL required to be filed under rules in effect before July 1, 2000, so a political organization remains liable for the tax on its investment income due under § 527(b).

FILING INFORMATION

Any paper forms and correspondence filed in accordance with this notice should contain the following information at the top of the form and on the envelope.

This is filed in accordance with Notice 2002–34.

Electronic versions of Forms 8871 and 8872 are not required to include this information.

DRAFTING INFORMATION

The principal author of this notice is Judith E. Kindell of the Exempt Organizations Rulings and Agreements Division. For further information regarding this notice, please call TE/GE Customer Service at 877–829–5500 (a toll-free call).

ATTACHMENT — POLITICAL ORGANIZATION FILING REQUIREMENTS

Tax-exempt political organizations, as defined in § 527 of the Internal Revenue Code (political organizations), must file some or all of four forms as a condition of tax-exempt status. This attachment discusses the filing requirements for political organizations without regard to the voluntary compliance program announced in this notice.

Political organizations include parties, committees, associations, funds or other entities organized and operated "primarily for the purpose of directly or indirectly accepting contributions or making expenditures." Political organizations accept contributions and make expenditures for the purpose of influencing the "selection, nomination, election, or appointment of any individual to Federal, State, or local public office or office in a political organization, or the election of Presidential electors." Political organizations include political party committees, Federal, State and local candidate committees and other political committees such as political action committees (PACs).

Who Has to File

The filing requirements in the chart below apply to those political organizations that:

- wish to be exempt from federal income tax provisions, and
- receive or expect to receive $25,000 or more in gross receipts in any taxable year

If You Are A	***You File***
Federal candidate committee, political party committee, or PAC required to report to the Federal Election Commission (FEC)	➢ Form 1120–POL; and ➢ Form 990 or Form 990–EZ
State or local candidate committee or state or local committee of a political party	➢ Form 8871; ➢ Form 1120–POL; and ➢ Form 990 or Form 990–EZ
Any other political organization, including state or local PACs and federal political organizations that are not required to report to the FEC	➢ Form 8871; ➢ Form 8872; ➢ Form 1120–POL; and ➢ Form 990 or Form 990–EZ

NOTE: You still file a Form 1120–POL if you are:

- A political organization that does not seek tax-exemption, or
- A tax-exempt political organization that does not have gross receipts of at least $25,000, but does receive in excess of $100 in taxable income in any taxable year.

Form Filing Requirements

1. Form 8871 — Notice of 527 Status

To be tax-exempt, a political organization that expects to receive $25,000 or more in gross receipts in any taxable year must file Form 8871 with the IRS, unless it is required to report as a political committee to the FEC. Form 8871, *Political Organization Notice of 527 Status*, must be filed both electronically and in writing, within 24 hours of the political organization's establishment. Until the political organization files the form, its income (including contributions) is subject to taxation and is reported on Form 1120–POL.

2. Form 8872 — Report of Contributions and Expenditures

Political organizations file Form 8872, *Political Organization Report of Contributions and Expenditures*, to disclose information concerning:

- persons receiving expenditures that aggregate $500 or more per person, per calendar year; and
- persons making contributions that aggregate $200 or more per person, per calendar year.

A political organization that does not disclose this information must pay an amount equal to the highest corporate tax rate (35 percent) multiplied by the amount of contributions and expenditures not disclosed and report this on the Form 1120–POL. If a political organization does not file Form 8871 and is subject to tax on its income, it is not required to file Form 8872.

For filing dates, see Q&A–28 through Q&A–33 of Rev. Rul. 2000–49.

3. Form 1120–POL — *U.S. Income Tax Return for Certain Political Organizations*

Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations*, is due by the 15th day of the 3rd month after the end of the organization's taxable year. Political organizations may request a six-month extension of the filing deadline by filing Form 7004, *Application for Automatic Extension of Time to File Corporate Income Tax Return*. This extension must be filed by the due date of

Form 1120–POL. There is a penalty for failure to file Form 1120–POL.

4. Form 990 or 990–EZ — *Return of Organization Exempt from Income Tax*

Exempt political organizations with gross receipts of less than $100,000 and assets of less than $250,000 at the end of the year may file a Form 990–EZ, *Short Form Return of Organization Exempt From Income Tax*. All other exempt political organizations should file a Form 990, *Return of Organization Exempt From Income Tax*.

Forms 990 or 990–EZ are due on the 15th day of the 5th month after the end of the organization's taxable year. There is a penalty for failure to file this return.

Organizations may request a three-month extension, without showing cause, by filing Form 8868, *Application for Extension of Time to File an Exempt Organization Return*, by the due date. A second three-month extension, with cause, may also be requested through Form 8868.

Form	When filed	Exceptions to filing requirement
8871	Within 24 hours of establishment	➢ Political committee required to report to the FEC; ➢ Organization that reasonably expects annual gross receipts to always be less than $25,000
8872	At organization's option, quarterly/semiannually or monthly, on same basis for entire calendar year (see form instructions for detailed information)	➢ Political committees required to report to the FEC; ➢ State and local committees of political parties; ➢ Campaign committees of state and local candidates; ➢ Organizations that reasonably expect gross receipts to always be less than $25,000
1120–POL	Due the 15th day of the 3rd month after the close of the taxable year	➢ Political organizations whose annual gross receipts are less than $25,000, and who have taxable income less than $100
990 or 990–EZ	Due the 15th day of the 5th month after the close of the taxable year	➢ Political organizations whose annual gross receipts are less than $25,000

Tax Avoidance Using Notional Principal Contracts

Notice 2002–35

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a notional principal contract ("NPC") to claim current deductions for periodic payments made by a taxpayer ("T") while disregarding the accrual of a right to receive offsetting payments in the future. The NPC has a term of more than one year. Under the NPC, *T* is required to make periodic payments to *CP* at regular intervals of one year or less based on a fixed or floating rate index. In return, *CP* is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison to the contingent component, may be based upon a fixed or floating interest rate. The contingent component may reflect changes in the value of a stock index or currency.

T may fund its obligation to make periodic payments in whole or in part by borrowing funds from a lender, who may be *CP*. In addition, *T* may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction. *T* may engage in short-term trading activity in securities with a view to establishing a trade or business. *T* may also engage in the transaction through a partnership, in which case instead of *T*, the partnership may engage in some or all of the activities described above. *T* will likely enter into an agreement with *CP* to terminate the NPC prior to the scheduled payment date of *CP*'s payment.

T deducts the ratable daily portion of each periodic payment for the taxable year to which that portion relates. However, *T* does not accrue income with respect to the nonperiodic payment until the year the payment is received. *T* intends to report as capital any gain it realizes upon the termination of the NPC.

ANALYSIS

The requirement of § 1.446–3(f)(2)(i) that a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract must be applied separately to the noncontingent component of the contract, whether that component is based on a fixed or a floating interest rate.

For a discussion of the proper treatment of the periodic and nonperiodic payments made pursuant to the interest rate swap if the noncontingent component is based on a fixed interest rate, *see* Rev. Rul. 2002–30 (2002–21 I.R.B. 971), May 28, 2002 (holding that the nonperiodic payment must be accrued ratably over the term of the NPC). In addition, depending on the facts of the particular case, the Service may challenge the purported tax results of these transactions on other grounds, including by: (i) recharacterizing one or more of the transactions under §§ 1.446–3(g)(2) or 1.446–3(i); (ii) determining that the swap expense, if any, was not incurred in the course of a trade or business and was therefore subject to the 2-percent floor limitation in section 67 of the Internal Revenue Code; (iii) disregarding the combination of the loans and the periodic payments as circular flows of cash; or (iv) applying other variations of the doctrine of substance-over-form.

The Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under section 6662, the return preparer penalty under section 6694, the promoter penalty under section 6700, and the aiding and abetting penalty under section 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002–35 are identified as "listed transactions" for purposes of § 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the Temporary Procedure and Administrative Regulations. *See also* § 301.6112–1T, A–4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A–4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A–3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under section 6707(a), and to the penalty under section 6708(a) if the requirements of section 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

The principal author of this Notice is Elizabeth Handler of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Handler at (202) 622–3930 (not a toll-free call).

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26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, §§ 61, 446, 451, 481, 1012; 1.61–1, 1.446–1, 1.451–1, 1.481–1, 1.1012–1.)

Rev. Proc. 2002–36

SECTION 1. PURPOSE

This revenue procedure provides taxpayers that purchase vehicles subject to leases and assume the associated leases from motor vehicle dealers with a safe harbor method of accounting for capital cost reduction payments ("CCR payments") made by vehicle lessees. This revenue procedure also provides a procedure for taxpayers to obtain automatic consent of the Commissioner to change to the safe harbor method of accounting.

SECTION 2. BACKGROUND

.01 Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided, gross income means all income from whatever source derived.

.02 Section 451(a) and § 1.451–1(a) of the Income Tax Regulations provide that the amount of any item of gross income should be included in a taxpayer's gross income for the taxable year in which actually or constructively received by the taxpayer, unless, under the taxpayer's method of accounting, such amount is properly includible for a different year.

.03 Section 1012 provides that the basis of property is the cost of the property. In general, section 1.1012–1(a) provides that the cost is the amount paid for the property in cash or other property.

.04 Under § 446(e) and § 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.

.05 The Treasury Department and the Internal Revenue Service are aware that the proper tax treatment of CCR payments by purchasers of leased vehicles has become a source of significant controversy. For reasons of administrative convenience and to avoid further controversy in this area, Treasury and the Service have determined that it is appropriate to provide purchasers with a safe harbor method of accounting for CCR payments, under which a CCR payment is excluded from the purchaser's basis in the purchased vehicle (and is excluded from the purchaser's gross income). Treasury and the Service believe the scope of the safe harbor method provided in this revenue procedure is appropriate given the current vehicle lease market and lease financing market. However, Treasury and the Service may modify the scope of this safe harbor method as necessary to respond to changes in leasing market conditions.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who purchase motor vehicles subject to leases in connection with which a lessee has made a CCR payment, as defined in section 4.01 of this revenue procedure, to the dealer/lessor of the vehicle at the inception of the lease.

SECTION 4. DEFINITIONS

.01 *CCR Payment*. A CCR payment is any payment made at the inception of a motor vehicle lease by the lessee to the dealer from which the vehicle is leased that has the effect of reducing the total amount of rent the lessee will pay after inception of the lease. A CCR payment may consist of a cash down payment, the trade-in value of a lessee's used vehicle, a rebate or incentive supplied by the manufacturer to the lessee, credits earned under a credit card reward program, or the first or last monthly rental payment. A CCR payment does not include refundable security deposits; extended service plan fees; insurance premiums; title, registration, or license fees; sales, lease, excise, use, or *ad valorem* taxes paid in advance or collected by the dealer; or administrative fees; made by a lessee in connection with a motor vehicle lease.

.02 *Taxpayer*. A "taxpayer" for purposes of this revenue procedure is a purchaser of a motor vehicle that is subject to a lease in connection with which a lessee has made a CCR payment to the dealer from which the lessee originally leased the vehicle.

SECTION 5. CCR METHOD

Under the CCR method, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle.

SECTION 6. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE CCR METHOD

A taxpayer within the scope of this revenue procedure that is using the CCR method provided in section 5 of this revenue procedure on May 3, 2002, may continue to use this safe harbor method for taxable years ending on or after May 3, 2002, without filing a Form 3115, *Application to Change a Method of Accounting*. Such taxpayer's method of excluding CCR payments from both its gross income and its basis in the purchased vehicle will not be raised as an issue in a taxable year that ends before May 3, 2002. Moreover, if such taxpayer's method of excluding CCR payments from both its gross income and its basis in the purchased vehicle is already an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9 (2002–3 I.R.B. 327)) in a taxable year that ends before May 3, 2002, the issue will not be further pursued.

SECTION 7. CHANGE IN METHOD OF ACCOUNTING

.01 *Limitations, Terms, and Conditions*. A change to the CCR method provided by this revenue procedure will be treated as a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Therefore, a taxpayer within the scope of this revenue procedure that does not use the CCR method provided in section 5 of this revenue procedure on May 3, 2002, but wants to use this safe harbor method for taxable years ending on or after December 31, 2001, must file a Form 3115.

.02 *Automatic Change to CCR Method*. A taxpayer within the scope of this revenue procedure that wants to change to the CCR method provided by section 5 of this revenue procedure must follow the automatic change in method of accounting provisions of Rev. Proc. 2002–9 (or its successor), as modified by Rev. Proc. 2002–19 (2002–13 I.R.B. 696) 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 make the change for its first or second taxable year ending on or after December 31, 2001;

(2) When filing the Form 3115, taxpayers must complete all applicable parts of the form and, in lieu of the label required by section 6.02(4) of Rev. Proc. 2002–9, are instructed to write "Filed under Rev. Proc. 2002–36" at the top of the form.

.03 *Section 481(a) Adjustment*. As provided in section 2 of Rev. Proc. 2002–19, the period for negative § 481(a) adjustments is one year, and the period for positive § 481(a) adjustments is four years.

.04 *Audit Protection*. If a taxpayer complies with the requirements of this revenue procedure and changes its method of accounting for CCR payments to the CCR method provided in section 5 of this revenue procedure, the treatment of CCR payments will not be raised as an issue in any taxable year before the year of change and, if the treatment of CCR payments is already an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9) in a taxable year before the year of change, that issue will not be further pursued.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this automatic change in section 5A of the APPENDIX.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Joy Ruff of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Ruff at (202) 622–5020 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Notice of Significant Reduction in the Rate of Future Benefit Accrual

REG–136193–01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the requirements of section 4980F of the Internal Revenue Code (Code) and section 204(h) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, which apply to defined benefit plans and to individual account plans that are subject to the funding standards of section 412 of the Code and section 302 of ERISA. These regulations provide guidance on the requirements for plan administrators to give notice of plan amendments to adversely affected plan participants and other parties when those amendments provide for a significant reduction in the rate of future benefit accrual or the elimination or significant reduction in an early retirement benefit or retirement-type subsidy. These regulations will affect retirement plan sponsors and administrators, participants in and beneficiaries of retirement plans, and employee organizations representing retirement plan participants. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 22, 2002. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for August 15, 2002, at 10 a.m., must be received by July 22, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–136193–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–136193–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Seventh Floor, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Janet A. Laufer at (202) 622–6090 or Diane S. Bloom at (202) 283–9888; concerning submissions, Donna Poindexter at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S Washington, DC 20224. Comments on the collection of information should be received by June 24, 2002. Comments are specifically requested concerning:

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

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

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

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

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

The collections of information in this proposed regulation are in § 54.4980F–1. Responses to this collection of information are required in order to obtain a benefit. Specifically, this information is required for a taxpayer who wants to amend a plan that is subject to the requirements of section 204(h) or section 4980F to significantly reduce the rate of future benefit accrual or significantly reduce an early retirement benefit or retirement-type subsidy. This information will be used to notify participants, alternate payees, and employee organizations of the amendment.

Estimated total annual reporting burden: 40,000 hours

The estimated annual burden per respondent varies from one hour to 80 hours, depending on individual circumstances, with an estimated average of 10 hours.

Estimated number of respondents: 4,000

Estimated annual frequency of responses: Once

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

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

Background

Section 204(h) was added to ERISA by section 11006(a) of the Single-Employer Pension Plan Amendments Act of 1986, Title XI of Public Law 99–272

(100 Stat. 237) and was amended by section 1879(u)(1) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2913) (TRA '86). As amended by TRA '86, section 204(h) of ERISA (section 204(h)) required a plan administrator to provide notice to participants and other interested persons after the date of adoption and at least 15 days before the effective date of a plan amendment providing for a significant reduction in the rate of future benefit accrual.

Pursuant to section 101(a) of Reorganization Plan No. 4 of 1978, 29 U.S.C. 1001nt, the Secretary of the Treasury generally has authority to issue regulations under parts 2 and 3 of subtitle B of title I of ERISA, including section 204 of ERISA. Under section 104 of Reorganization Plan No. 4, the Secretary of Labor retains enforcement authority with respect to parts 2 and 3 of subtitle B of title I of ERISA, but, in exercising such authority, is bound by the regulations issued by the Secretary of the Treasury. On December 15, 1995, temporary regulations (T.D. 8631, 1996–1 C.B. 54), under section 411 of the Internal Revenue Code (Code), 26 U.S.C. 411, were published in the **Federal Register** (60 FR 64320), along with a notice of proposed rulemaking (EE–34–95, 1996–1 C.B. 761) cross-referencing the temporary regulations (60 FR 64401). Those temporary regulations addressed the notice requirements of section 204(h). On December 14, 1998, final regulations (T.D. 8795, 1999–1 C.B. 459) addressing the notice requirements of section 204(h) were published in the **Federal Register**. See § 1.411(d)–6.

Section 659 of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (EGTRRA) added section 4980F of the Code, which imposes an excise tax when a plan administrator fails to provide timely notice of plan amendments that provide for a significant reduction in the rate of future benefit accrual, and, for this purpose, treats the elimination or reduction of an early retirement benefit or retirement-type subsidy as a reduction in the rate of future benefit accrual. EGTRRA also amended section 204(h) to treat the elimination or reduction of an early retirement benefit or retirement-type subsidy as a reduction in the rate of future benefit accrual. The requirement in section 204(h)(1) that notice be given after the date of adoption and at least 15 days in advance of the amendment's effective date was replaced by a requirement contained in both section 4980F(e)(3) and section 204(h)(3) that, except as provided in regulations, the notice be provided within a "reasonable time" before the effective date of the amendment. The notice requirements in section 4980F of the Code are essentially identical to the notice requirements in section 204(h), as amended by EGTRRA. In addition, section 204(h) has been amended by EGTRRA to provide that, in the case of an egregious failure to meet the notice requirements, the provisions of the plan are applied as if the amendment entitled applicable individuals to the greater of the benefits to which they would have been entitled without regard to the amendment or the benefits under the plan as amended.

The Job Creation and Worker Assistance Act of 2002, Public Law 107–147 (116 Stat. 21) included certain technical corrections to section 659 of EGTRRA.

These proposed regulations, when finalized, would replace the Treasury regulations currently at § 1.411(d)–6 to reflect the EGTRRA changes outlined above. Since the notice requirements of section 204(h) are now also required under section 4980F of the Code, these proposed regulations are issued under section 4980F, but apply for purposes of section 204(h), as well as for purposes of section 4980F.

Explanation of Provisions

Statutory Requirements After EGTRRA

Section 4980F(e) of the Code and section 204(h) of ERISA require notice to be provided when a defined benefit plan or a money purchase pension or other individual account plan that is subject to the funding standards of section 412 of the Code is amended to significantly reduce the rate of future benefit accrual. This notice must be provided to participants and alternate payees for whom the amendment is reasonably expected to significantly reduce the rate of future benefit accrual, and to employee organizations representing such participants. For purposes of these rules, an amendment that eliminates or reduces an early retirement benefit or retirement-type subsidy is treated as an amendment that reduces the rate of future benefit accrual. The notice must contain sufficient information (as determined in accordance with regulations) to enable such individuals to understand the effect of the amendment and, except to the extent provided in regulations, must be provided within a reasonable time before the effective date of the amendment. Additionally, section 4980F(e)(2) of the Code and section 204(h)(2) of ERISA authorize the Secretary to provide special rules for plans covering fewer than 100 participants and for plans that offer participants the option to choose between the new benefit formula and the old benefit formula.

A plan amendment that is subject to the notice requirements of section 4980F of the Code and section 204(h) of ERISA (section 204(h) amendment) may be subject to additional reporting and disclosure requirements under title I of ERISA, such as the requirement to provide a summary of material modifications (SMM) describing the amendment. Notice under section 4980F of the Code and section 204(h) of ERISA (referred to in the proposed regulations as section 204(h) notice) must be provided in accordance with the provisions of these regulations even though sections 102(a) and 104(b) of ERISA also may require that an SMM describing the plan amendment be furnished to participants covered under the plan and beneficiaries receiving benefits under the plan. The Department of Labor has advised the IRS that, at least until the effective date of final regulations under section 4980F of the Code, a plan administrator that provides a section 204(h) notice to applicable individuals in accordance with these proposed regulations will be treated as having furnished those individuals with an SMM regarding the section 204(h) amendment. The plan administrator is required to satisfy any other requirements regarding the furnishing of SMMs or updated summary plan descriptions, including, for example, satisfaction of the requirement to furnish an SMM to any other participants covered under the plan, and to beneficiaries receiving benefits under the plan, who are entitled to an SMM regarding the amendment.

Time for Providing Section 204(h) Notice Under Proposed Regulations

The proposed regulations aim to strike a balance between giving participants and other affected parties section 204(h) notice long enough in advance to enable them to understand and consider the information before the amendment goes into effect, and allowing employers the ability to effect changes to their plans for business reasons (such as to facilitate business reorganizations or to permit small businesses the flexibility to reduce costs promptly) within a reasonable time. The Treasury Department and IRS have concluded, based on the history of the legislation, that the reason why the 15-day advance notice required under section 204(h) as it existed prior to EGTRRA was replaced by the "reasonable time" standard is because the 15-day standard was perceived as often being insufficient. Accordingly, these proposed regulations would provide that a reasonable time generally means at least 45 days before the effective date of the plan amendment.

However, the proposed regulations include certain special timing rules, including rules that would allow section 204(h) notice to be provided as late as 15 days before the effective date of the amendment in two types of cases. First, the proposed regulations would generally permit section 204(h) notice to be provided 15 days in advance for amendments adopted in connection with business mergers and acquisitions. Second, the proposed regulations include a 15-day advance notice requirement with respect to amendments of small plans. Thus, the 15-day standard that was in section 204(h) before EGTRRA would generally continue to apply for small plans and for amendments adopted in connection with business mergers and acquisitions for which notice would have been required under section 204(h) as in effect before EGTRRA. The proposed regulations provide an additional special timing rule that applies in the case of an amendment that is adopted in connection with a business merger or acquisition involving a plan-to-plan transfer or merger and that affects only an early retirement benefit or retirement-type subsidy (but does not reduce the rate of future benefit accrual). In the case of such an amendment, the notice must be provided no later than 30 days after the effective date of the amendment.

In the case of a plan amendment which offers participants the option to choose between the new benefit formula and the old benefit formula, the general timing rules would apply, except that the proposed regulations would allow certain additional information to be provided at a later date, as described in *Content of Section 204(h)Notice* of this preamble.

Content of Section 204(h) Notice

Section 4980F(e)(2) of the Code and section 204(h)(2) of ERISA require section 204(h) notice to be written in a manner calculated to be understood by the average plan participant and to provide sufficient information (as determined in accordance with regulations) to allow applicable individuals to understand "the effect of" the amendment.

The Conference report for EGTRRA states that the changes to the section 204(h) of ERISA notice requirements were expected to "provide for alternative disclosures rather than a single disclosure methodology that may not fit all situations," and also notes "the need to consider the complex actuarial calculations and assumptions involved in providing necessary disclosures." H.R. Rep. 107–84, at 266. In addition, particular concern was expressed about the effects of conversion of traditional defined benefit plans to cash balance or hybrid formula plans and the effects of "wear-away" provisions under which participants earn no additional benefits for a period of time after conversion. H.R. Rep. 107–84, at 266.

The content requirements in these proposed regulations take into account this background and generally seek to ensure that adversely affected participants receive sufficient information to enable them to understand the impact and magnitude of the changes being made to their pension plan, without imposing unduly burdensome requirements on employers and while permitting latitude to employers in diverse businesses with varying employee demographics to determine how to communicate plan changes in an appropriately effective manner. Accordingly, the proposed regulations provide general standards for the content of a section 204(h) notice, rather than containing specific requirements for each type of notice.

The proposed regulations require a section 204(h) notice to include sufficient information to allow applicable individuals to understand the effect of the plan amendment, including the approximate magnitude of the expected reduction. The type and amount of information necessary to satisfy this standard varies depending on the nature of the change resulting from the amendment. The information must be written in a manner calculated to be understood by the average plan participant. The notice must describe the affected provisions prior to plan amendment, describe these provisions as amended, and state the effective date of the amendment. This description of plan provisions might be similar to the description of a plan's benefit accrual formula in a summary plan description that satisfies the requirements under § 2520.102–3 of the Department of Labor regulations. If the amendment applies by its terms differently to various classes of employees (such as where the amendment applies differently depending on what division an employee is in), the explanation must include sufficient information to allow an affected participant to understand the general class or classes of participants to whom the reduction applies. Also, these proposed regulations clarify that, in cases in which a plan amendment affects different classes of applicable individuals differently, the plan administrator may provide different section 204(h) notices. A section 204(h) notice cannot include materially false or misleading information (or omit information so as to cause the information provided to be misleading).

If a section 204(h) amendment reduces an early retirement benefit or retirement-type subsidy merely as a result of reducing the rate of future benefit accrual, the section 204(h) notice need not contain a separate description of that reduction in the early retirement benefit or retirement-type subsidy.

Additional information may be necessary to make the approximate magnitude of the reduction apparent. In cases in which it is not reasonable to expect that the approximate magnitude of the reduction will be reasonably apparent from a narrative description, one or more illustrative examples are required to be included in the notice. Thus, for example, illustrative examples would be required for a change from a traditional defined benefit formula to a cash balance formula or a change that results in a period of time during which there are no accruals with regard to normal retirement benefits or an early retirement subsidy (a wear-away period). However, examples are not required to illustrate circumstances under which a participant's benefit may increase as a result of the section 204(h) amendment.

Where an amendment may result in reductions that vary in their impact on applicable individuals, the examples must show the approximate range of the reductions. However, the range of reductions need not include reductions that are likely to occur in only a *de minimis* number of cases if a narrative statement is included to that effect (for example, such a narrative might state that larger or smaller reductions may occur in some other cases) and examples are provided that show the approximate range of the reductions in cases other than this *de minimis* number. For amendments for which the maximum reduction occurs under identifiable circumstances with proportionately smaller reductions in other cases, the range of reductions can be illustrated by one example illustrating the maximum reduction, with a statement that smaller reductions also occur. Further, assuming that the reduction varies from small to large depending on service or other factors, as might occur for an amendment that results in a wear-away, two illustrative examples may be provided showing the smallest likely reduction and the largest likely reduction.

Examples are not required to be based on any particular form of payment (such as a life annuity or a single sum), but may be based on whatever form appropriately illustrates the reduction. The examples may be based on any reasonable assumptions, such as assumptions relating to age, service, and compensation (and salary scale assumptions for amendments that alter the compensation taken into account under the plan, such as a change from a final pay plan to a career average pay plan), but the section 204(h) notice must identify those assumptions. The proposed regulations include special rules for determining whether an amendment is reasonably expected to result in a wear-away period.

The proposed regulations include special rules for any case in which an applicable individual can choose between the new formula and the old formula. Under these rules, the individual must be provided sufficient information to enable the individual to make an informed choice between the new and old benefit formulas. The information to enable the individual to make an informed choice is not required to be provided at the same time as section 204(h) notice is otherwise required to be provided, as long as it is provided within a period that is reasonably contemporaneous with the individual's choice and that allows sufficient advance notice to enable the individual to understand and consider the additional information before making the choice.

A section 204(h) notice may include more information than is required, but cannot include any false or misleading information and cannot include so much additional information that the required information fails to be provided in a manner calculated to come to the attention of applicable individuals. While a notice for an amendment converting a traditional final pay plan to a cash balance plan must include an estimate of the future normal retirement benefit of the participant in the illustration even if that requires an estimate of future wage increases, a section 204(h) notice could also include alternative estimates. For example, an alternative estimate could be based on an assumption that there are no future wage increases.

The proposed regulations include several examples, including examples that are intended to show the illustrations that are required for a cash balance conversion amendment that is based on a very simplified form of conversion. For more complex conversion amendments, it is expected that more illustrations may be appropriate. However, these regulations do not require section 204(h) notice to include different illustrative examples to address the amount of the reduction for every demographic variation (*e.g.*, differences in compensation or years of service).

Excise Tax Under Internal Revenue Code Section 4980F(c)(1)

Section 4980F(c)(1) of the Code provides that no excise tax is imposed on a failure for any period during which it is established to the satisfaction of the Secretary that the employer (or other person responsible for the tax) did not know that the failure existed and exercised reasonable diligence to meet the notice requirements. The proposed regulations provide that the requirements of section 4980F(c)(1) of the Code are satisfied if and only if the person that would be responsible for the tax exercised reasonable diligence in attempting to deliver timely section 204(h) notice to applicable individuals (by the latest date permitted under the regulations) and believed that section 204(h) notice was actually and timely delivered to each applicable individual. An example of this illustrates that section 4980F(c)(1) of the Code would apply to a situation in which a plan administrator relies on an overnight delivery service to send materials to the persons who are expected to hand deliver section 204(h) notice to participants, and the overnight delivery service is late in making that delivery.

ERISA Provisions Regarding Egregious Failures

Section 204(h)(6)(A) of ERISA, as amended by EGTRRA, provides that in the case of an egregious failure to meet the notice requirements, the provisions of the plan are applied as if the plan amendment entitled applicable individuals to the greater of the benefits to which they would have been entitled without regard to the amendment or the benefits under the plan as amended. Section 204(h)(6)(B) of ERISA provides that, for this purpose, there is an egregious failure to meet the section 204(h) notice requirements if such failure is within the control of the plan sponsor and is an intentional failure (including any failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure to meet notice requirements) or a failure to provide most of the individuals with most of the information they are entitled to receive. The proposed regulations provide that a failure is not egregious if the plan administrator reasonably determines, taking into account the statute, administrative guidance, and relevant facts and circumstances, that the reduction is not significant. The proposed regulations clarify that, in the case of a failure that is not egregious, the failure will not preclude the amendment from becoming effective. However, where there is a failure, whether or not egregious, recourse may be available under ERISA section 502 to, among other things, recover benefits due under the plan, enforce rights under the terms of the plan, clarify rights to future benefits under the plan, obtain equitable relief, or otherwise redress such violation. This might occur, for example, if a participant receives and thus uses materially inadequate or misleading information in making a choice between the new and the old benefit formula.

Method of Delivery of Section 204(h) Notice

As a general standard, the section 204(h) notice either must be provided through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing the notice results in actual receipt. Therefore, section 204(h) notice may not be provided by "posting."

Section 4980F(g) of the Code and section 204(h)(7) of ERISA, as amended by EGTRRA, state that the Secretary of Treasury may by regulation allow 204(h) notice to be provided using new technologies. Because those provisions specifically relate to electronic delivery and were enacted after enactment of the Electronic Signatures in Global and National Commerce Act (114 Stat. 464) (2000) (E-SIGN Act), the authority conferred by those provisions on the Secretary to decide whether to permit, and under what conditions to permit, electronic delivery of section 204(h) notice is not constrained by the provisions of the E-SIGN Act.

Section 4980F(g) of the Code and section 204(h)(7) of ERISA give the Secretary of the Treasury authority to impose appropriate criteria for the provision of section 204(h) notice through electronic methods to ensure that applicable individuals will receive section 204(h) notice electronically and are able to access it timely. As noted above, section 204(h) notice either must be provided through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing the notice results in actual receipt. These proposed regulations would apply the same standard to the electronic delivery of section 204(h) notice by requiring that the method used result in actual receipt or that the plan administrator take appropriate and necessary measures to ensure that any provision of the notice in electronic format results in actual receipt of the transmitted information. Additionally, the plan administrator must offer to provide each applicable individual a paper version of the notice free of charge. Of course, the requirements of these regulations must otherwise be satisfied when section 204(h) notice is provided in electronic format. The proposed regulations include a number of examples illustrating the rules applicable to the electronic provision of a section 204(h) notice and also include a safe harbor, which has conditions similar to the consumer protection provisions of section 101(c) of the E-SIGN Act.

Under the proposed regulations, permitted electronic means for furnishing section 204(h) notice would include e-mail, a site on the Internet, or other electronic communications site, and a DVD or CD that could generally be accessed using a computer at an employee's worksite. However, section 204(h) notice information is not considered provided merely because it is available through a computer kiosk, even when the kiosk is at the individual's workplace and the individual is otherwise provided notice of the availability of information at the kiosk, because, like posting, providing such information through a kiosk places a burden on participants to seek out the information. Nevertheless, information made available through a kiosk is considered provided to those applicable individuals who actually access the information through the kiosk.

Proposed Effective Date

These proposed regulations would apply to amendments that go into effect on or after the date that is 120 days after publication of final regulations in the **Federal Register**. The proposed regulations also restate the general statutory effective date and special effective date rules that are in section 659(c) of EGTRRA. Thus, the proposed regulations include the transition rule of section 659(c)(2) of EGTRRA that provides that, for amendments taking effect on or after the date of enactment of EGTRRA (June 7, 2001) and prior to the effective date of the final regulations, the notice requirements of section 4980F(e)(2) and (3) of the Code, and of section 204(h) of ERISA as amended by EGTRRA, are treated as satisfied if the plan administrator makes a reasonable, good faith effort to comply with those requirements.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that the collection of information in these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that small entities generally do not have very complex benefit structures in their plans, or many different classes of participants who will be differently affected by an amendment reducing the rate of future benefit accrual. Small entities also have fewer employees, and so those small entities that are required to provide section 204(h) notice need to provide it to fewer individuals. Accordingly, the time required for them to prepare and provide section 204(h) notice will usually be modest. Furthermore, because most small entities will only be affected when they amend the retirement plans they sponsor to reduce or eliminate benefits, and most small entities will not so amend the retirement plans frequently, it is generally expected that most small entities would be required to provide section 204(h) notice only once over the course of several years. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 15, 2002, beginning at 10 a.m., in the IRS Auditorium, Seventh Floor, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the main entrance, located at 1111 Constitution Avenue, NW. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 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" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and time to be devoted to each topic (preferably a signed original and eight (8) copies) by July 22, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Janet A. Laufer, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 54 are 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 * * *

§ 1.411(d)(6) [Removed]

Par. 2. Section 1.411(d)–6 is removed.

PART 54—PENSION EXCISE TAXES

Par. 3. The authority citation for part 54 is amended by adding the following citation in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
§ 54.4980F–1 is also issued under 26 U.S.C. 4980.* * *

Par. 4 Section 54.4980F–1 is added to read as follows:

§ 54.4980F–1 Notice requirements for certain pension plan amendments significantly reducing benefit accruals.

(a) *Table of contents*. This paragraph contains a list of the questions in § 54. 4980F–1(b).

Q–1. What are the notice requirements of section 4980F(e) of the Internal Revenue Code and section 204(h) of ERISA?
Q–2. What are the differences between section 4980F and section 204(h)?
Q–3. What is an "applicable pension plan" to which section 4980F of the Internal Revenue Code and section 204(h) apply?
Q–4. What is "section 204(h) notice" and what is a "section 204(h) amendment"?
Q–5. For which amendments is section 204(h) notice required?
Q–6. What is an amendment that reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy for purposes of determining whether section 204(h) notice is required?
Q–7. What plan provisions are taken into account in determining whether an amendment is a section 204(h) amendment?
Q–8. What is the basic principle used in determining whether a reduction in the rate of future benefit accrual or an early retirement benefit or retirement-type subsidy is significant for purposes of section 204(h)?
Q–9. When must section 204(h) notice be provided?
Q–10. To whom must section 204(h) notice be provided?
Q–11. What information is required to be provided in a section 204(h) notice?
Q–12. What special rules apply if participants can choose between the old and new benefit formulas?
Q–13. How may section 204(h) notice be provided?
Q–14. What are the consequences if a plan administrator fails to provide section 204(h) notice?
Q–15. What are some of the rules that apply with respect to the excise tax under section 4980F?
Q–16. How do section 4980F and section 204(h) apply when a business is sold?
Q–17. How are amendments to cease accruals and terminate a plan treated under section 4980F and section 204(h)?
Q–18. What is the effective date of section 4980F of the Internal Revenue Code, section 204(h) of ERISA, as amended by EGTRRA, and these regulations?

(b) *Questions and answers*. The questions and answers are as follows:

Q–1. What are the notice requirements of section 4980F(e) of the Internal Revenue Code and section 204(h) of ERISA?

A–1. (a) *Requirements of Internal Revenue Code section 4980F(e) and ERISA section 204(h)*. Section 4980F of the Internal Revenue Code (section 4980F) and section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), 29 U.S.C. 1054(h) (section 204(h)) each generally requires notice of an amendment to an applicable pension plan that either provides for a significant reduction in the rate of future benefit accrual or that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. The notice is required to be provided to plan participants or alternate payees who are applicable individuals (as defined in Q&A–10 of this section) and to certain employee organizations. The plan administrator must generally provide the notice before the effective date of the plan amendment. Q&A–9 of this section sets forth the time frames for providing notice, Q&A–11 of this section sets forth the content requirements for the notice, and Q&A–12 of this section contains special rules for cases in which participants can choose between the old and new benefit formulas.

(b) *Other notice requirements*. Other provisions of law may require that certain parties be notified of a plan amendment. See, for example, sections 102 and 104 of ERISA, and the regulations thereunder, for requirements relating to summary plan descriptions and summaries of material modifications.

Q–2. What are the differences between section 4980F and section 204(h)?

A–2. Section 4980F was added to the Internal Revenue Code by the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (2001) (EGTRRA). EGTRRA also amended section 204(h) to, among other things, extend the notice requirement to a plan amendment that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy, even if it does not significantly reduce the rate of future benefit accrual. The notice requirements of section 4980F generally are parallel to the notice requirements of section 204(h), as amended by EGTRRA. However, the consequences of the two provisions differ: section 4980F imposes an excise tax on a failure to satisfy the notice requirements, while section 204(h)(6), as amended by EGTRRA, contains a special rule with respect to egregious failures. See Q&A–14 and Q&A–15 of this section. Except to the extent specifically indicated, these regulations apply both to section 4980F and to section 204(h).

Q–3. What is an "applicable pension plan" to which section 4980F and section 204(h) apply?

A–3. (a) *In general*. Section 4980F and section 204(h) apply to an applicable pension plan. For purposes of section 4980F, an *applicable pension plan* means a defined benefit plan qualifying under section 401(a) or 403(a) of the Internal Revenue Code, or an individual account plan that is subject to the funding standards of section 412 of the Internal Revenue Code. For purposes of section 204(h), an *applicable pension plan* means a defined benefit plan that is subject to part 2 of subtitle B of title I of ERISA, or an individual account plan that is subject to such part 2 and to the funding standards of section 412 of the Internal Revenue Code. Accordingly, individual account plans that are not subject to the funding standards of section 412 of the Internal Revenue Code, such as profit-sharing and stock bonus plans, are not applicable pension plans to which section 4980F or section 204(h) apply . Similarly, a defined benefit plan that neither qualifies under section 401(a) or 403(a) of the Internal Revenue Code nor is subject to part 2 of subtitle B of title I of ERISA is not an applicable pension plan. Further, neither a governmental plan (within the meaning of section 414(d) of the Internal Revenue Code), nor a church plan (within the meaning of section 414(e) of the Internal Revenue Code) with respect to which no election has been made under section 410(d) of the Internal Revenue Code is an applicable pension plan.

(b) *Section 204(h) notice not required for small plans covering no employees*. Section 204(h) notice is not required for a plan under which no employees are participants covered under the plan, as described in § 2510.3–3(b) of the Department of Labor regulations, and which has fewer than 100 participants.

Q–4. What is "section 204(h) notice" and what is a "section 204(h) amendment"?

A–4. *Section 204(h) notice* is notice that complies with section 4980F(e), section 204(h)(1), and this section. A *section 204(h) amendment* is an amendment for which section 204(h) notice is required under this section.

Q–5. For which amendments is section 204(h) notice required?

A–5. (a) *Significant reduction in the rate of future benefit accrual*. Section 204(h) notice is required for an amendment to an applicable pension plan that provides for a significant reduction in the rate of future benefit accrual, including a cessation of benefit accrual.

(b) *Early retirement benefits and retirement-type subsidies*. Section 204(h) notice is required for an amendment to an applicable pension plan that provides for the significant reduction of an early retirement benefit or retirement-type subsidy. For purposes of this section, *early retirement benefit* and *retirement-type subsidy* mean early retirement benefits and retirement-type subsidies within the meaning of section 411(d)(6)(B)(i).

(c) *Elimination or cessation of benefits*. For purposes of this section, the terms *reduce* or *reduction* include *eliminate* or *cease* or *elimination* or *cessation*.

(d) *Delegation of authority to Commissioner*. The Commissioner may provide in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) that section 204(h) notice need not be provided for plan amendments otherwise described in paragraph (a) or (b) of this Q&A–5 that the Commissioner determines to be necessary or appropriate, as a result of changes in the law, to maintain compliance with the requirements of the Internal Revenue Code (including requirements for tax qualification), ERISA, or other applicable federal law.

Q–6. What is an amendment that reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy for purposes of determining whether section 204(h) notice is required?

A–6. (a) *In general*. For purposes of determining whether section 204(h) notice is required, an amendment reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy only as provided in paragraph (b) or (c) of this Q&A–6.

(b) *Reduction in rate of future benefit accrual*—(1) *Defined benefit plans*. For purposes of section 4980F and section 204(h), an amendment to a defined benefit plan reduces the rate of future benefit accrual only if it is reasonably expected to reduce the amount of the future annual benefit commencing at normal retirement age for benefits accruing for a year. For this purpose, the annual benefit commencing at normal retirement age is the benefit payable in the form in which the terms of the plan express the accrued benefit (or, in the case of a plan in which the accrued benefit is not expressed in the form of an annual benefit commencing at normal retirement age, the benefit payable in the form of a single life annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit expressed under the terms of the plan, as determined in accordance with section 411(c)(3) of the Internal Revenue Code).

(2) *Individual account plans*. For purposes of section 4980F and section 204(h), an amendment to an individual account plan reduces the rate of future benefit accrual only if it is reasonably expected to reduce the amounts allocated in the future to participants' accounts for a year. Changes in the investments or investment options under an individual account plan are not taken into account for this purpose.

(3) *Determination of rate of future benefit accrual*. The rate of future benefit accrual for purposes of this paragraph (b) is determined without regard to optional forms of benefit within the meaning of § 1.411(d)–4, Q&A–1(b) of this chapter (other than the annual benefit described in paragraph (b)(1) of this Q&A–6). The rate of future benefit accrual is also determined without regard to ancillary benefits and other rights or features as defined in § 1.401(a)(4)–4(e) of this chapter.

(c) *Reduction of early retirement benefits or retirement-type subsidies*. For purposes of section 4980F and section 204(h), an amendment reduces an early retirement benefit or retirement-type subsidy only if it is reasonably expected to eliminate or reduce an early retirement benefit or retirement-type subsidy.

Q–7. What plan provisions are taken into account in determining whether an amendment is a section 204(h) amendment?

A–7. (a) *Plan provisions taken into account*. All plan provisions that may affect the rate of future benefit accrual, early retirement benefits, or retirement-type subsidies of participants or alternate payees must be taken into account in determining whether an amendment is a section 204(h) amendment. For example, plan provisions that may affect the rate of future benefit accrual include the dollar amount or percentage of compensation on which benefit accruals are based; the definition of service or compensation taken into account in determining an employee's benefit accrual; the method of determining average compensation for calculating benefit accruals; the definition of normal retirement age in a defined benefit plan; the exclusion of current participants from future participation; benefit offset provisions; minimum benefit provisions; the formula for determining the amount of contributions and forfeitures allocated to participants' accounts in an individual account plan; in the case of a plan using permitted disparity under section 401(l) of the Internal Revenue Code, the amount of disparity between the excess benefit percentage or excess contribution percentage and the base benefit percentage or base contribution percentage (all as defined in section 401(l) of the Internal Revenue Code); and the actuarial assumptions used to determine contributions under a target benefit plan (as defined in § 1.401(a)(4)–8(b)(3)(i) of this chapter). Plan provisions that may affect early retirement benefits or retirement-type subsidies include the right to receive payment of benefits after severance from employment and before normal retirement age and actuarial factors used in determining optional forms for distribution of retirement benefits.

(b) *Plan provisions not taken into account*. Plan provisions that do not affect the rate of future benefit accrual of participants or alternate payees are not taken into account in determining whether there has been a reduction in the rate of future benefit accrual. Further, any benefit that is not a section 411(d)(6) protected benefit as described in § 1.411(d)–4, Q&A–1(d) of this chapter, or that is a section 411(d)(6) protected benefit that may be eliminated or reduced as permitted under § 1.411(d)–4, Q&A–2(a) or (b) of this chapter, is not taken into account in determining whether an amendment is a section 204(h) amendment. Thus, for example, provisions relating to vesting schedules or the right to make after-tax contributions or elective deferrals are not taken into account.

(c) *Example*. The following example illustrates the rules in this Q&A–7:

Example. (i) *Facts*. A defined benefit plan provides a normal retirement benefit equal to 50% of final average compensation times a fraction (not in excess of one), the numerator of which equals the number of years of participation in the plan and the denominator of which is 20. A plan amendment is adopted that changes the numerator or denominator of that fraction.

(ii) *Conclusion*. The plan amendment must be taken into account in determining whether there has been a reduction in the rate of future benefit accrual.

Q–8. What is the basic principle used in determining whether a reduction in the rate of future benefit accrual or a reduction in an early retirement benefit or retirement-type subsidy is significant for purposes of section 204(h)?

A–8. (a) *General rule*. Whether an amendment reducing the rate of future benefit accrual or reducing an early retirement benefit or retirement-type subsidy provides for a reduction that is significant for purposes of section 204(h) is determined based on reasonable expectations taking into account the relevant facts and circumstances at the time the amendment is adopted.

(b) *Application for determining significant reduction in the rate of future benefit accrual*. For a defined benefit plan, the determination of whether an amendment provides for a significant reduction in the rate of future benefit accrual is made by comparing the amount of the annual benefit commencing at normal retirement age, as determined under Q&A–6(b)(1) of this section, under the terms of the plan as amended with the amount of the annual benefit commencing at normal retirement age, as determined under Q&A–6(b)(1) of this section, under the terms of the plan prior to amendment. For an individual account plan, the determination of whether an amendment provides for a significant reduction in the rate of future benefit accrual is made in accordance with Q&A–6(b)(2) of this section by comparing the amounts to be allocated in the future to participants' accounts under the terms of the plan as amended with the amounts to be allocated in the future to participants' accounts under the terms of the plan prior to amendment.

(c) *Application to certain amendments reducing early retirement benefits or retirement-type subsidies*. Because section 204(h) notice is required only for reductions that are significant, section 204(h) notice is not required for an amendment that reduces an early retirement benefit or retirement-type subsidy if the amendment is permitted under the third sentence of section 411(d)(6)(B) of the Internal Revenue Code and regulations thereunder (relating to the elimination or reduction of benefits or subsidies which create significant burdens or complexities for the plan and plan participants unless the amendment adversely affects the rights of any participant in a more than *de minimis* manner).

Q–9. When must section 204(h) notice be provided?

A–9. (a) *45-day general rule*. Except as described in paragraphs (b) and (c) of this Q&A–9, section 204(h) notice must be provided at least 45 days before the effective date of any section 204(h) amendment. See paragraph (d) of this Q&A–9 for special rules for amendments permitting participant choice.

(b) *15-day rule for small plans*. Except for amendments described in paragraph (c)(2) of this Q&A–9, in the case of a small plan, section 204(h) notice must be at least 15 days before the effective date of any section 204(h) amendment. For purposes of this section, a small plan is a plan that the plan administrator reasonably expects to have, on the effective date of the section 204(h) amendment, fewer than 100 participants who have an accrued benefit under the plan.

(c) *Special timing rule for business transactions*—(1) *15-day rule for section 204(h) amendment in connection with an acquisition or disposition*. Except for amendments described in paragraph (c)(2) of this Q&A–9, if a section 204(h) amendment is adopted in connection with an acquisition or disposition, section 204(h) notice must be provided at least 15 days before the effective date of the section 204(h) amendment.

(2) *Later notice permitted for section 204(h) amendment significantly reducing early retirement benefit or retirement-type subsidies in connection with certain plan transfers, mergers, or consolidations*. If a section 204(h) amendment is adopted with respect to liabilities that are transferred to another plan in connection with a transfer, merger, or consolidation of assets or liabilities as described in section 414(l) of the Internal Revenue Code and § 1.414(l)–1 of this chapter, the amendment is adopted in connection with an acquisition or disposition, and the amendment significantly reduces an early retirement benefit or retirement-type subsidy, but does not significantly reduce the rate of future benefit accrual, then section 204(h) notice must be provided no later than 30 days after the effective date of the section 204(h) amendment.

(3) *Definition of acquisition or disposition*. For purposes of this paragraph (c), see § 1.410(b)–2(f) of this chapter for the definition of acquisition or disposition.

(d) *Timing rule for amendments permitting participant choice*. In general, section 204(h) notice of a section 204(h) amendment that provides applicable individuals with a choice between the old and the new benefit formulas (as described in Q&A–12 of this section) must be provided in accordance with the time period applicable under paragraphs (a) through (c) of this Q&A–9. See Q&A–12 of this section for additional guidance regarding section 204(h) notice in connection with participant choice.

Q–10. To whom must section 204(h) notice be provided?

A–10. (a) *In general*. Section 204(h) notice must be provided to each applicable individual and to each employee organization representing participants who are applicable individuals. A special rule is provided in paragraph (d) of this Q&A–10.

(b) *Applicable individual*. Applicable individual means each participant in the plan, and any alternate payee, whose rate of future benefit accrual under the plan may reasonably be expected to be significantly reduced, or for whom an early retirement benefit or retirement-type subsidy under the plan may reasonably be expected to be significantly reduced, by the section 204(h) amendment.

(c) *Alternate payee*. Alternate payee means a beneficiary who is an alternate payee (within the meaning of section 414(p)(8) of the Internal Revenue Code) under an applicable qualified domestic relations order (within the meaning of section 414(p)(1)(A) of the Internal Revenue Code).

(d) *Designees*. Section 204(h) notice may be provided to a person designated in writing by an applicable individual or by an employee organization representing participants who are applicable individuals, instead of being provided to that applicable individual or employee organization. Any designation of a representative made through an electronic method that satisfies standards similar to those of Q&A–13(c)(1) of this section satisfies the requirement that a designation be in writing.

(e) *Facts and circumstances test*. Whether a participant or alternate payee is an applicable individual is determined based on all relevant facts and circumstances at the time the section 204(h) notice must be provided (or is provided, if earlier).

(f) *Examples*. The following examples illustrate the rules in this Q&A–10:

Example 1. (i) *Facts*. A defined benefit plan requires an individual to complete 1 year of service to become a participant who can accrue benefits, and participants cease to accrue benefits under the plan at severance from employment with the employer. There are no alternate payees and employees are not represented by an employee organization. The plan is amended effective as of January 1, 2005, to significantly reduce the rate of future benefit accrual.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, on January 1, 2005, have completed at least 1 year of service and are employed by the employer.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that the sole effect of the plan amendment is to alter the pre-amendment plan provisions under which benefits payable to an employee who retires after 20 or more years of service are unreduced for commencement before normal retirement age. The amendment requires 30 or more years of service in order for benefits commencing before normal retirement age to be unreduced, but the amendment only applies for future benefit accruals.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, on January 1, 2005, have completed at least 1 year of service but less than 30 years of service, are employed by the employer, have not attained normal retirement age, and will have completed 20 or more years of service before normal retirement age if their employment continues to normal retirement age.

Example 3. (i) *Facts*. A plan is amended to reduce significantly the rate of future benefit accrual for all current employees who are participants. Based on the facts and circumstances, it is reasonable to expect that the amendment will not reduce the rate of future benefit accrual of former employees who are currently receiving benefits or of former employees who are entitled to deferred vested benefits.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to any former employees.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that the plan covers two groups of alternate payees. The alternate payees in the first group are entitled to a certain percentage or portion of the former spouse's accrued benefit and, for this purpose, the accrued benefit is determined at the time the former spouse begins receiving retirement benefits under the plan. The alternate payees in the second group are entitled to a certain percentage or portion of the former spouse's accrued benefit and, for this purpose, the accrued benefit was determined at the time the qualified domestic relations order was issued by the court.

(ii) *Conclusion*. It is reasonable to expect that the benefits to be received by the second group of alternate payees will not be affected by any reduction in a former spouse's rate of future benefit accrual. Accordingly, the plan administrator is not required to provide section 204(h) notice to the alternate payees in the second group.

Example 5. (i) *Facts*. A plan covers hourly employees and salaried employees. The plan provides the same rate of benefit accrual for both groups. The employer amends the plan to reduce significantly the rate of future benefit accrual of the salaried employees only. At that time, it is reasonable to expect that only a small percentage of hourly employees will become salaried in the future.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to the participants who are currently hourly employees.

Example 6. (i) *Facts*. A plan covers employees in Division M and employees in Division N. The plan provides the same rate of benefit accrual for both groups. The employer amends the plan to reduce significantly the rate of future benefit accrual of employees in Division M. At that time, it is reasonable to expect that in the future only a small percentage of employees in Division N will be transferred to Division M.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to the participants who are employees in Division N.

Example 7. (i) *Facts*. The facts are the same facts as in *Example 6*, except that at the time the amendment is adopted, it is expected that thereafter Division N will be merged into Division M in connection with a corporate reorganization (and the employees in Division N will become subject to the plan's amended benefit formula applicable to the employees in Division M).

(ii) *Conclusion*. In this case, the plan administrator must provide section 204(h) notice to the participants who are employees in Division M and to the participants who are employees in Division N.

Q–11. What information is required to be provided in section 204(h) notice?

A–11. (a) *Explanation of amendment*—(1) *In general*. Section 204(h) notice must include sufficient information to allow applicable individuals to understand the effect of the plan amendment, including the approximate magnitude of the expected reduction. To the extent any expected reduction is not uniformly applicable to all participants, the notice must either identify the general classes of participants to whom the reduction is expected to apply, or by some other method include sufficient information to allow each applicable individual receiving the notice to determine which reductions are expected to apply to that individual. The information must be written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice. The type and amount of information necessary to satisfy these standards will vary depending on the nature of the change resulting from the amendment, as described further in paragraphs (a)(2) and (3) of this Q&A–11.

(2) *Required narrative*—(i) *Reduction in rate of future benefit accrual*. In the case of an amendment reducing the rate of future benefit accrual, the notice must include a description of the benefit or allocation formula prior to the amendment, a description of the benefit or allocation formula under the plan as amended, and the effective date of the amendment.

(ii) *Reduction in early retirement benefit or retirement-type subsidy*. In the case of an amendment that reduces an early retirement benefit or retirement-type subsidy (other than as a result of an amendment reducing the rate of future benefit accrual), the notice must describe how the early retirement benefit or retirement-type subsidy is calculated from the accrued benefit before the amendment, how the early retirement benefit or retirement-type subsidy is calculated from the accrued benefit after the amendment, and the effective date of the amendment. For example, if, for a plan with a normal retirement age of 65, the change is from an unreduced normal retirement benefit at age 55 to an unreduced normal retirement benefit at age 60 for benefits accrued in the future, with an actuarial reduction to apply for benefits accrued in the future to the extent that the early retirement benefit begins before age 60, the notice must state that and specify the factors that apply in calculating the actuarial reduction (*e.g.*, a 5% per year reduction applies for early retirement before age 60).

(3) *Additional required information*—(i) *Standard for additional information*. In cases in which it is not reasonable to expect that the approximate magnitude of the reduction will be reasonably apparent from the description provided in accordance with in paragraph (a)(2) of this Q&A–11, further information is required. This requirement can be satisfied by furnishing additional narrative information, as described in paragraph (a)(3)(ii) of this Q&A–11; by furnishing illustrative examples, as described in paragraph (a)(3)(iii) of this Q&A–11; or through a combination of these.

(ii) *Additional narrative information*. Further narrative explanation of the effect of the difference between the old and new formulas or benefit calculation may be provided to make the approximate magnitude of the reduction apparent.

(iii) *Illustrative examples*—(A) *Requirement generally*. In cases in which it is not reasonable to expect that the approximate magnitude of the reduction will be reasonably apparent from the description provided in accordance with in paragraph (a)(2) of this Q&A–11 (plus any additional narrative information provided in accordance with paragraph (a)(3)(ii) of this Q&A–11), the notice must include one or more illustrative examples showing the approximate magnitude of the reduction in the example. Thus, illustrative examples are required for a change from a traditional defined benefit formula to a cash balance formula or a change that results in a period of time during which there are no accruals (or minimal accruals) with regard to normal retirement benefits or an early retirement subsidy (a wear-away period).

(B) *Examples must bound the range of reductions*. Where an amendment results in reductions that vary (as would occur for an amendment converting a traditional defined benefit formula to a cash balance formula or an amendment that results in a wear-away period), the illustrative example(s) provided in accordance with this paragraph (a)(3)(iii) must show the approximate range of the reductions. However, any reductions that are likely to occur in only a *de minimis* number of cases are not required to be taken into account in determining the range of the reductions if a narrative statement is included to that effect and examples are provided that show the approximate range of the reductions in other cases. Amendments for which the maximum reduction occurs under identifiable circumstances, with proportionately smaller reductions in other cases, may be illustrated by one example illustrating the maximum reduction, with a statement that smaller reductions also occur. Further, assuming that the reduction varies from small to large depending on service or other factors, two illustrative examples may be provided showing the smallest likely reduction and the largest likely reduction.

(C) *Assumptions used in examples*. The examples required under this paragraph (a)(3)(iii) are not required to be based on any particular form of payment (such as a life annuity or a single sum), but may be based on whatever form appropriately illustrates the reduction. The examples generally may be based on any reasonable assumptions (*e.g.*, assumptions relating to the representative participant's age, years of service, and compensation, along with any interest rate and mortality table used in the illustrations, as well as salary scale assumptions used in the illustrations for amendments that alter the compensation taken into account under the plan), but the section 204(h) notice must identify those assumptions. However, if a plan's benefit provisions include a factor that varies over time (such as a variable interest rate), the determination of whether an amendment is reasonably expected to result in a wear-away period must be based on the value of the factor applicable under the plan at a time that is reasonably close to the date section 204(h) notice is provided, and any wear-away period that is solely a result of a future change in the variable factor may be disregarded. For example, to determine whether a wear-away occurs as a result of a section 204(h) amendment that converts a defined benefit plan to a cash balance pension plan that will credit interest based on a variable interest factor specified in the plan, the future interest credits must be projected based on the interest rate applicable under the variable factor at the time section 204(h) notice is provided.

(4) *No false or misleading information*. A notice that includes materially false or misleading information (or omits information so as to cause the information provided to be misleading) does not constitute section 204(h) notice.

(b) *Additional information when reduction not uniform*—(1) *In general*. If an amendment by its terms affects different classes of participants differently (*e.g.*, one new benefit formula will apply to Division A and another to Division B), then the requirements of paragraph (a) of this Q&A–11 apply separately with respect to each such general class of participants. In addition, the notice must include sufficient information to enable an applicable individual who is a participant to understand which class he or she is a member of.

(2) *Option for different section 204(h) notices*. If a section 204(h) amendment affects different classes of applicable individuals differently, the plan administrator may provide to differently affected classes of applicable individuals a section 204(h) notice appropriate to those individuals. Such section 204(h) notice may omit information that does not apply to the applicable individuals to whom it is furnished, but must identify the class or classes of applicable individuals to whom it is provided.

(c) *Examples*. The following examples illustrate the requirements of paragraph (a) of this Q&A–11. In each example it is assumed that the notice is written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice.

Example 1. (i) *Facts*. Plan A provides that a participant is entitled to a normal retirement benefit of 2% of the participant's average pay over the 3 consecutive years for which the average is the highest (highest average pay) multiplied by years of service. Plan A is amended to provide that, effective January 1, 2004, the normal retirement benefit will be 2% of the participant's highest average pay multiplied by years of service before the effective date, plus 1% of the participant's highest average pay multiplied by years of service after the effective date. The plan administrator provides notice that states: "Under the Plan's current benefit formula, a participant's normal retirement benefit is 2% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by the participant's years of service. This formula is being changed by a plan amendment. Under the Plan as amended, a participant's normal retirement benefit will be the sum of 2% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by years of service before the effective date, plus 1% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by the participant's years of service after the effective date. This change is effective on January 1, 2004." The notice does not contain any additional information.

(ii) *Conclusion*. The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 2. (i) *Facts*. Plan B provides that a participant is entitled to a normal retirement benefit at age 64 of 2.2% of the participant's career average pay times years of service. Plan B is amended to cease all accruals, effective January 1, 2004. The plan administrator provides notice that includes a description of the old benefit formula, a statement that after December 31, 2003, no participant will earn any further accruals, and the effective date of the amendment.

(ii) *Conclusion*. The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 3. (i) *Facts*. Plan C provides that a participant is entitled to a normal retirement benefit at age 65 of 2% of career average compensation times years of service. Plan C is amended to provide that the normal retirement benefit will be 1% of average pay over the 3 consecutive years for which the average is the highest times years of service. The amendment only applies to accruals for years of service after the amendment, so that each employee's accrued benefit is equal to the sum of the benefit accrued as of the effective date of the amendment plus the accrued benefit equal to the new formula applied to years of service beginning on or after the effective date. The plan administrator provides notice that describes the old and new benefit formulas and also explains that for an individual whose compensation increases over the individual's career such that the individual's highest 3-year average exceeds the individual's career average, the reduction will be less or there may be no reduction.

(ii) *Conclusion*. The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 4. (i) *Facts*. (A) Plan D is a defined benefit pension plan under which each participant accrues a normal retirement benefit, as a life annuity beginning at the normal retirement age of 65, equal to the participant's number of years of service times 1.5 percent times the participant's average pay over the 3 consecutive years for which the average is the highest. Plan D provides early retirement benefits for former employees beginning at or after age 55 in the form of an early retirement annuity that is actuarially equivalent to the normal retirement benefit, with the reduction for early commencement based on reasonable actuarial assumptions that are specified in Plan D. Plan D provides for the suspension of benefits of participants who continue in employment beyond normal retirement age, in accordance with section 203(a)(3)(B) of ERISA and regulations thereunder issued by the Department of Labor. The pension of a participant who retires after age 65 is calculated under the same normal retirement benefit formula, but is based on the participant's service credit and highest 3-year pay at the time of late retirement with any appropriate actuarial increases.

(B) Plan D is amended, effective July 1, 2005, to change the formula for all future accruals to a cash balance formula under which the opening account balance for each participant on July 1, 2005, is zero, hypothetical pay credits equal to 5 percent of pay are credited to the account thereafter, and hypothetical interest is credited monthly based on the applicable interest rate under section 417(e)(3) of the Internal Revenue Code at the beginning of the quarter. Any participant who terminates employment with vested benefits can receive an actuarially equivalent annuity (based on the same reasonable actuarial assumptions that are specified in Plan D) commencing at any time after termination of employment and before the plan's normal retirement age of 65. The benefit resulting from the hypothetical account balance is in addition to the benefit accrued on June 30, 2005 (taking into account only service and highest 3-year pay before July 30, 2005), so that it is reasonably expected that no wear-away period will result from the amendment. The plan administrator expects that, as a general rule, depending on future pay increases and future interest rates, the rate of future benefit accrual after the conversion is higher for participants who accrue benefits before approximately age 50 and after approximately age 70, but is lower for participants who accrue benefits between approximately age 50 and age 70.

(C) The plan administrator of Plan D announces the conversion to a cash balance formula on May 16, 2005. The announcement is delivered to all participants and includes a written notice that describes the old formula, the new formula, and the effective date.

(D) In addition, the notice states that the Plan D formula before the conversion provided a normal retirement benefit equal to the product of a participant's number of years of service times 1.5 percent times the participant's average pay over the 3 years for which the average is the highest (highest 3-year pay). The notice includes an example showing the normal retirement benefit that will be accrued after June 30, 2005, for a participant who is age 49 with 10 years of service at the time of the conversion. The plan administrator believes that such a participant is representative of the participants whose rate of future benefit accrual will be reduced as a result of the amendment. The example estimates that, if the participant continues employment to age 65, the participant's normal retirement benefit for service from age 49 to age 65 will be $657 per month for life. The example assumes that the participant's pay is $50,000 at age 49. The example states that the estimated $657 monthly pension accrues over the 16-year period from age 49 to age 65 and that, based on assumed future pay increases, this amount annually would be 9.1 percent of the participant's highest 3-year pay at age 65, which over the 16 years from age 49 to age 65 averages 0.57 percent per year times the participant's highest 3-year pay. The example also states that the sum of the monthly annuity accrued before the conversion in the 10-year period from age 39 to age 49 plus the $657 monthly annuity estimated to be accrued over the 16-year period from age 49 to age 65 is $1,235 and that, based on assumed future increases in pay, this would be 17.1 percent of the participant's highest 3-year pay at age 65, which over the employee's career from age 39 to age 65 averages 0.66 percent per year times the participant's highest 3-year pay. The notice also includes two other examples with similar information, one of which is intended to show the circumstances in which a small reduction may occur and the other of which shows the largest reduction that the plan administrator thinks is likely to occur. The notice states that the estimates are based on the assumption that pay increases annually after June 30, 2005, at a 4 percent rate. The notice also specifies that the applicable interest rate under section 417(e) for hypothetical interest credits after June 30, 2005, is assumed to be 6 percent, which is the section 417(e) of the Internal Revenue Code applicable interest rate under the plan for 2005.

(ii) *Conclusion*. The information in the notice, as described in paragraph (i)(C) of this *Example 4*, satisfies the requirements of paragraph (a)(2) of this Q&A–11 with respect to applicable individuals who are participants. The additional requirements of paragraph (a)(3) of this Q&A–11 are satisfied because, as noted in paragraph (i)(D) of this *Example 4*, the notice describes the old formula and describes the estimated future accruals under the new formula in terms that can be readily compared to the old formula, *i.e.*, the notice states that the estimated $657 monthly pension accrued over the 16-year period from age 49 to age 65 averages 0.57 percent of the participant's highest 3-year pay at age 65. The requirement that the examples include sufficient information to be able to determine the approximate magnitude of the reduction would also be satisfied if the notice instead directly stated the amount of the monthly pension that would have accrued over the 16-year period from age 49 to age 65 under the old formula.

Example 5. (i) *Facts*. The facts are the same as in *Example 4*, except that, under the plan as in effect before the amendment, the early retirement pension for a participant who terminates employment after age 55 with at least 20 years of service is equal to the normal retirement benefit without reduction from age 65 to age 62 and reduced by only 5 percent per year for each year before age 62. As a result, early retirement benefits for such a participant constitute a retirement-type subsidy. The plan as in effect after the amendment provides an early retirement benefit equal to the sum of the early retirement benefit payable under the plan as in effect before the amendment taking into account only service and highest 3-year pay before July 1, 2005, plus an early retirement annuity that is actuarially equivalent to the account balance for service after June 30, 2005. The notice provided by the plan administrator describes the old early retirement annuity, the new early retirement annuity, and the effective date. The notice includes an estimate of the early retirement annuity payable to the illustrated participant for service after the conversion if the participant were to retire at age 59 (which the plan administrator believes is a typical early retirement age) and elect to begin receiving an immediate early retirement annuity. The example states that the normal retirement benefit expected to be payable at age 65 as a result of service from age 49 to age 59 is $434 per month for life beginning at age 65 and that the early retirement annuity expected to be payable as a result of service from age 49 to age 59 is $270 per month for life beginning at age 59. The example states that the monthly early retirement annuity of $270 is 38 percent less than the monthly normal retirement benefit of $434, whereas a 15 percent reduction would have applied under the plan as in effect before the amendment. The notice also includes similar information for examples that show the smallest and largest reduction that the plan administrator thinks is likely to occur in the early retirement benefit. The notice also specifies the applicable interest rate, mortality table, and salary scale used in the example to calculate the early retirement reductions.

(ii) *Conclusion*. The information in the notice, as described in paragraphs (i)(C) and (i)(D) of *Example 4* and paragraph (i) of this *Example 5*, satisfies the requirements of paragraph (a) of this Q&A–11 with respect to applicable individuals who are participants. The requirements of paragraph (a)(3) of this Q&A–11 are satisfied because, as noted in paragraph (i) of this *Example 5*, the notice describes the early retirement subsidy under the old formula and describes the estimated early retirement pension under the new formula in terms that can be readily compared to the old formula, *i.e.*, the notice states that the monthly early retirement pension of $270 is 38 percent less than the monthly normal retirement benefit of $434, whereas a 15 percent reduction would have applied under the plan as in effect before the amendment. The requirements of paragraph (a)(1) of this Q&A–11 would also be satisfied if the notice instead directly stated the amount of the monthly early retirement pension that would be payable at age 59 under the old formula.

Q–12. What special rules apply if participants can choose between the old and new benefit formulas?

A–12. In any case in which an applicable individual can choose between the benefit formula (including any early retirement benefit or retirement-type subsidy) in effect before the section 204(h) amendment (old formula) or the benefit formula in effect after the section 204(h) amendment (new formula), section 204(h) notice has not been provided unless the applicable individual has been provided the information required under Q&A–11 of this section, and has also been provided sufficient information to enable the individual to make an informed choice between the old and new benefit formulas. The information required under Q&A–11 of this section must be provided by the date otherwise required under Q&A–9 of this section. The information sufficient to enable the individual to make an informed choice must be provided within a period that is reasonably contemporaneous with the date by which the individual is required to make his or her choice and that allows sufficient advance notice to enable the individual to understand and consider the additional information before making that choice.

Q–13. How may section 204(h) notice be provided?

A–13. (a) A plan administrator (including a person acting on behalf of the plan administrator, such as the employer or plan trustee) must provide section 204(h) notice through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice. Section 204(h) notice must be provided either in the form of a paper document or in an electronic form that satisfies the requirements of paragraph (c) of this Q&A–13. First class mail to the last known address of the party is an acceptable delivery method. Likewise, hand delivery is acceptable. However, the posting of notice is not considered provision of section 204(h) notice. Section 204(h) notice may be enclosed with or combined with other notice provided by the employer or plan administrator (for example, a notice of intent to terminate under title IV of ERISA). Except as provided in paragraph (c) of this Q&A–13, a section 204(h) notice is deemed to have been provided on a date if it has been provided by the end of that day. When notice is delivered by first class mail, the notice is considered provided as of the date of the United States postmark stamped on the cover in which the document is mailed.

(b) *Example*. The following example illustrates the provisions of paragraph (a) of this Q&A–13:

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual effective January 1, 2005. Under Q&A–9 of this section, section 204(h) notice is required to be provided at least 45 days before the effective date of the amendment. The plan administrator causes section 204(h) notice to be mailed to all affected participants. The mailing is postmarked November 16, 2004.

(ii) *Conclusion*. Because section 204(h) notice is given 45 days before the effective date of the plan amendment, it satisfies the timing requirement of Q&A–9 of this section.

(c) *New technologies*—(1) *General rule*. A section 204(h) notice may be provided to an applicable individual through an electronic method (other than an oral communication or a recording of an oral communication), provided that all of the following requirements are satisfied:

(i) Either the notice is actually received by the applicable individual or the plan administrator takes appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice by the applicable individual.

(ii) The plan administrator provides the applicable individual with a clear and conspicuous statement, in electronic or non-electronic form, that the applicable individual has a right to request and obtain a paper version of the section 204(h) notice without charge and, if such request is made, the applicable individual is furnished with the paper version without charge.

(iii) The requirements of this section must otherwise be satisfied. Thus, for example, a section 204(h) notice provided through an electronic method must be delivered on or before the date required under Q&A–9 of this section and must satisfy the requirements set forth in Q&A–11 of this section, including the content requirements and the requirements that it be written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice. Accordingly, when it is not otherwise reasonably evident, the recipient should be apprised (either in electronic or non-electronic form), at the time the notice is furnished electronically, of the significance of the notice.

(2) *Examples*. The following examples illustrate the requirement in paragraph (c)(1)(i) of this Q&A–13. In these examples, it is assumed that the notice satisfies the requirements in paragraph (c)(1)(ii) and (iii) of this section. The examples are as follows:

Example 1. (i) *Facts*. On July 1, 2003, M, a plan administrator of Company N's plan, sends notice intended to satisfy section 204(h) of ERISA to A, an employee of Company N and a participant in the plan. The notice is sent through e-mail to A's e-mail address on Company N's electronic information system. Accessing Company N's electronic information system is not an integral part of A's duties. M sends the e-mail with a request for a computer-generated notification that the message was received and opened. M receives notification indicating that the e-mail was received and opened by A on July 9, 2003.

(ii) *Conclusion*. With respect to A, although M has failed to take appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice, M satisfies the requirement of paragraph (c)(1)(i) of this Q&A–13 on July 9, 2003, which is when A actually receives the notice.

Example 2. (i) *Facts*. On August 1, 2003, O, a plan administrator of Company P's plan, sends a notice intended to satisfy section 204(h) of ERISA to B, who is an employee of Company P and a participant in Company P's plan. The notice is sent through e-mail to B's e-mail address on Company P's electronic information system. B has the ability to effectively access electronic documents from B's e-mail address on Company P's electronic information system and accessing the system is an integral part of B's duties.

(ii) *Conclusion*. Because access to the system is an integral part of B's duties, O has taken appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice. Thus, regardless of whether B actually accesses B's email on that date, O satisfies the requirement of paragraph (c)(1)(i) of this Q&A–13 on August 1, 2003, with respect to B.

(3) *Safe harbor in case of consent*. The requirement of paragraph (c)(1)(i) of this Q&A–13 is deemed to be satisfied with respect to an applicable individual if the section 204(h) notice is provided electronically to an applicable individual, and—

(i) The applicable individual has affirmatively consented electronically, or confirmed consent electronically, in a manner that reasonably demonstrates the applicable individual's ability to access the information in the electronic form in which the notice will be provided, to receiving section 204(h) notice electronically and has not withdrawn such consent;

(ii) The applicable individual has provided, if applicable, in electronic or non-electronic form, an address for the receipt of electronically furnished documents;

(iii) Prior to consenting, the applicable individual has been provided, in electronic or non-electronic form, a clear and conspicuous statement indicating—

(A) That the consent can be withdrawn at any time without charge;

(B) The procedures for withdrawing consent and for updating the address or other information needed to contact the applicable individual;

(C) Any hardware and software requirements for accessing and retaining the documents; and

(D) The information required by paragraph (c)(1)(ii) of this Q&A–13; and

(iv) After consenting, if a change in hardware or software requirements needed to access or retain electronic records creates a material risk that the applicable individual will be unable to access or retain the section 204(h) notice—

(A) The applicable individual is provided with a statement of the revised hardware and software requirements for access to and retention of the section 204(h) notice and is given the right to withdraw consent without the imposition of any fees for such withdrawal and without the imposition of any condition or consequence that was not disclosed at the time of the initial consent; and

(B) The requirement of paragraph (c)(3)(i) of this Q&A–13 is again complied with.

Q–14. What are the consequences if a plan administrator fails to provide section 204(h) notice?

A–14. (a) *Egregious failures*—(1) *Effect of egregious failure to provide section 204(h) notice*. Section 204(h)(6)(A) of ERISA provides that, in the case of any egregious failure to meet the notice requirements with respect to any plan amendment, the plan provisions are applied so that all applicable individuals are entitled to the greater of the benefit to which they would have been entitled without regard to the amendment, or the benefit under the plan with regard to the amendment. For a special rule applicable in the case of a plan termination, see Q&A–17(b) of this section.

(2) *Definition of egregious failure*. For purposes of section 204(h) of ERISA and this Q&A–14, there is an egregious failure to meet the notice requirements if a failure to provide required notice is within the control of the plan sponsor and is either an intentional failure or a failure, whether or not intentional, to provide most of the individuals with most of the information they are entitled to receive. For this purpose, an intentional failure includes any failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure to meet the requirements. A failure to give section 204(h) notice is deemed not to be egregious if the plan administrator reasonably determines, taking into account section 204(h) of ERISA, section 4980F of the Internal Revenue Code, these regulations, other administrative pronouncements, and relevant facts and circumstances, that the reduction in the rate of future benefit accrual resulting from an amendment is not significant (as described in Q&A–8 of this section), or that an amendment does not significantly reduce an early retirement benefit or retirement-type subsidy.

(3) *Example*. The following example illustrates the provisions of this paragraph (a):

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual effective January 1, 2003. Section 204(h) notice is required to be provided 45 days before January 1, 2003. Timely section 204(h) notice is provided to all applicable individuals (and to each employee organization representing participants who are applicable individuals), except that the employer intentionally fails to provide section 204(h) notice to certain participants until May 16, 2003.

(ii) *Conclusion*. The failure to provide section 204(h) notice is egregious. Accordingly, for the period from January 1, 2003, through June 30, 2003 (which is the date that is 45 days after May 16, 2003), all participants and alternate payees are entitled to the greater of the benefit to which they would have been entitled under Plan A as in effect before the amendment or the benefit under the plan as amended.

(b) *Effect of non-egregious failure to provide section 204(h) notice*. If an egregious failure has not occurred, the amendment with respect to which section 204(h) notice is required may become effective with respect to all applicable individuals. However, see section 502 of ERISA for civil enforcement remedies. Thus, where there is a failure, whether or not egregious, to provide section 204(h) notice in accordance with this section, individuals may have recourse under section 502 of ERISA.

(c) *Excise taxes*. See section 4980F of the Internal Revenue Code and Q&A–15 of this section for excise taxes that may apply to a failure to notify applicable individuals of a pension plan amendment that provides for a significant reduction in the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy, regardless of whether or not the failure is egregious.

Q–15. What are some of the rules that apply with respect to the excise tax under section 4980F?

A–15. (a) *Person responsible for excise tax*. In the case of a plan other than a multiemployer plan, the employer is responsible for reporting and paying the excise tax. In the case of a multiemployer plan, the plan is responsible for reporting and paying the excise tax.

(b) *Excise tax inapplicable in certain cases*. Under section 4980F(c)(1) of the Internal Revenue Code, no excise tax is imposed on a failure for any period during which it is established to the satisfaction of the Commissioner that the employer (or other person responsible for the tax) exercised reasonable diligence, but did not know that the failure existed. Under section 4980F(c)(2) of the Internal Revenue Code, no excise tax applies to a failure to provide section 204(h) notice if the employer (or other person responsible for the tax) exercised reasonable diligence and corrects the failure within 30 days after the employer (or other person responsible for the tax) first knew, or exercising reasonable diligence would have known, that such failure existed. For purposes of section 4980F(c)(1) of the Internal Revenue Code, a person has exercised reasonable diligence, but did not know that the failure existed if and only if—

(1) The person exercised reasonable diligence in attempting to deliver section 204(h) notice to applicable individuals by the latest date permitted under this section; and

(2) At the latest date permitted for delivery of section 204(h) notice, the person reasonably believes that section 204(h) notice was actually delivered to each applicable individual by that date.

(c) *Example*. The following example illustrates the provisions of paragraph (b) of this Q&A–15:

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual. The employer sends out a section 204(h) notice to all affected participants and other applicable individuals and to any employee organization representing applicable individuals, including actual delivery by hand to employees at worksites. However, although the employer exercises reasonable diligence in seeking to deliver the notice, the notice is not delivered to any participants at one worksite due to a failure of an overnight delivery service to provide the notice to appropriate personnel at that site for them to timely hand deliver the notice to affected employees. The error is discovered when the employer subsequently calls to confirm delivery. Appropriate section 204(h) notice is then promptly delivered to all affected participants at the worksite.

(ii) *Conclusion*. Because the employer exercised reasonable diligence, but did not know that a failure existed, no excise tax applies, assuming that participants at the worksite receive section 204(h) notice within 30 days after the employer first knew, or exercising reasonable diligence would have known, that the failure occurred.

Q–16. How do section 4980F and section 204(h) apply when a business is sold?

A–16. (a) *Generally*. Whether section 204(h) notice is required in connection with the sale of a business depends on whether a plan amendment is adopted that significantly reduces the rate of future benefit accrual or significantly reduces an early retirement benefit or retirement-type subsidy.

(b) *Examples*. The following examples illustrate the rules of this Q&A–16:

Example 1. (i) *Facts*. Corporation Q maintains Plan A, a defined benefit plan that covers all employees of Corporation Q, including employees in its Division M. Plan A provides that participating employees cease to accrue benefits when they cease to be employees of Corporation Q. On January 1, 2006, Corporation Q sells all of the assets of Division M to Corporation R. Corporation R maintains Plan B, which covers all of the employees of Corporation R. Under the sale agreement, employees of Division M become employees of Corporation R on the date of the sale (and cease to be employees of Corporation Q), Corporation Q continues to maintain Plan A following the sale, and the employees of Division M become participants in Plan B.

(ii) *Conclusion*. No section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. The employees of Division M who become employees of Corporation R ceased to accrue benefits under Plan A because their employment with Corporation Q terminated.

Example 2. (i) *Facts*. Subsidiary Y is a wholly owned subsidiary of Corporation S. Subsidiary Y maintains Plan C, a defined benefit plan that covers employees of Subsidiary Y. Corporation S sells all of the stock of Subsidiary Y to Corporation T. At the effective date of the sale of the stock of Subsidiary Y, in accordance with the sale agreement between Corporation S and Corporation T, Subsidiary Y amends Plan C so that all benefit accruals cease.

(ii) *Conclusion*. Section 204(h) notice is required to be provided because Subsidiary Y adopted a plan amendment that significantly reduced the rate of future benefit accrual in Plan C.

Example 3. (i) *Facts*. As a result of an acquisition, Corporation U maintains two plans: Plan D covers employees of Division N and Plan E covers the rest of the employees of Corporation U. Plan E provides a significantly lower rate of future benefit accrual than Plan D. Plan D is merged with Plan E, and all of the employees of Corporation U will accrue benefits under the merged plan in accordance with the benefit formula of former Plan E.

(ii) *Conclusion*. Section 204(h) notice is required.

Example 4.— (i) *Facts*. The facts are the same as in *Example 3*, except that the rate of future benefit accrual in Plan E is not significantly lower. In addition, Plan D has a retirement-type subsidy that Plan E does not have and the Plan D employees' rights to the subsidy under the merged plan are limited to benefits accrued before the merger.

(ii) *Conclusion*. Section 204(h) notice is required for any participants or beneficiaries for whom the reduction in the retirement-type subsidy is significant (and for any employee organization representing such participants).

Example 5. (i) *Facts*. Corporation V maintains several plans, including Plan F, which covers employees of Division P. Plan F provides that participating employees cease to accrue further benefits under the plan when they cease to be employees of Corporation V. Corporation V sells all of the assets of Division P to Corporation W, which maintains Plan G for its employees. Plan G provides a significantly lower rate of future benefit accrual than Plan F. Plan F is merged with Plan G as part of the sale, and employees of Division P who become employees of Corporation W will accrue benefits under the merged plan in accordance with the benefit formula of former Plan G.

(ii) *Conclusion*. No section 204(h) notice is required because no plan amendment was adopted that reduces the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. Under the terms of Plan F as in effect prior to the merger, employees of Division P cease to accrue any further benefits (including benefits with respect to early retirement benefits and any retirement-type subsidy) under Plan F after the date of the sale because their employment with Corporation V terminated.

Q–17. How are amendments to cease accruals and terminate a plan treated under section 4980F of the Internal Revenue Code and section 204(h) of ERISA?

A–17. (a) *General rule*—(1) *Rule*. An amendment providing for the cessation of benefit accruals on a specified future date and for the termination of a plan is subject to section 4980F of the Internal Revenue Code and section 204(h) of ERISA.

(2) *Example*. The following example illustrates the rule of paragraph (a)(1) of this Q&A–17:

Example. (i) *Facts*. An employer adopts an amendment that provides for the cessation of benefit accruals under a defined benefit plan on December 31, 2003, and for the termination of the plan pursuant to title IV of ERISA as of a proposed termination date that is also December 31, 2003. As part of the notice of intent to terminate required under title IV in order to terminate the plan, the plan administrator gives section 204(h) notice of the amendment ceasing accruals, which states that benefit accruals will cease "on December 31, 2003." However, because all the requirements of title IV for a plan termination are not satisfied, the plan cannot be terminated until a date that is later than December 31, 2003.

(ii) *Conclusion*. Nonetheless, because section 204(h) notice was given stating that the plan was amended to cease accruals on December 31, 2003, section 204(h) does not prevent the amendment to cease accruals from being effective on December 31, 2003. The result would be the same had the section 204(h) notice informed the participants that the plan was amended to provide for a proposed termination date of December 31, 2003, and to provide that "benefit accruals will cease on the proposed termination date whether or not the plan is terminated on that date." However, neither section 4980F of the Internal Revenue Code nor section 204(h) of ERISA would be satisfied with respect to the December 31, 2003, effective date if the section 204(h) notice had merely stated that benefit accruals would cease "on the termination date" or "on the proposed termination date."

(3) *Additional requirements under title IV of ERISA*. See 29 CFR 4041.23(b)(4) and 4041.43(b)(5) for special rules applicable to plans terminating under title IV of ERISA.

(b) *Terminations in accordance with title IV of ERISA*. A plan that is terminated in accordance with title IV of ERISA is deemed to have satisfied section 4980F of the Internal Revenue Code and section 204(h) of ERISA not later than the termination date (or date of termination, as applicable) established under section 4048 of ERISA. Accordingly, neither section 4980F of the Internal Revenue Code nor section 204(h) of ERISA would in any event require that any additional benefits accrue after the effective date of the termination.

(c) *Amendment effective before termination date of a plan subject to title IV of ERISA*. To the extent that an amendment providing for a significant reduction in the rate of future benefit accrual or a significant reduction in an early retirement benefit or retirement-type subsidy has an effective date that is earlier than the termination date (or date of termination, as applicable) established under section 4048 of ERISA, that amendment is subject to section 4980F of the Internal Revenue Code and section 204(h) of ERISA. Accordingly, the plan administrator must provide section 204(h) notice (either separately, with, or as part of the notice of intent to terminate) with respect to such an amendment.

Q–18. What is the effective date of section 4980F of the Internal Revenue Code, section 204(h) of ERISA, as amended by EGTRRA, and these regulations?

A–18. (a) *Statutory effective date*—(1) *General rule*. Section 4980F of the Internal Revenue Code and section 204(h) of ERISA, as amended by EGTRRA, apply to plan amendments taking effect on or after June 7, 2001 (statutory effective date), which is the date of enactment of EGTRRA.

(2) *Transition rule*. For amendments applying after the statutory effective date in paragraph (a)(1) of this Q&A–18 and prior to the regulatory effective date in paragraph (c) of this Q&A–18, the requirements of section 4980F(e)(2) and (3) of the Internal Revenue Code and section 204(h) of ERISA, as amended by EGTRRA, are treated as satisfied if the plan administrator makes a reasonable, good faith effort to comply with those requirements.

(3) *Special notice rule*—(i) *In general*. Notwithstanding Q&A–9 of this section, section 204(h) notice is not required by section 4980F(e) of the Internal Revenue Code or section 204(h) of ERISA, as amended by EGTRRA, to be provided prior to September 7, 2001 (the date that is three months after the date of enactment of EGTRRA).

(ii) *Reasonable notice*. The requirements of section 4980F of the Internal Revenue Code and section 204(h) of ERISA, as amended by EGTRRA, do not apply to any plan amendment that takes effect on or after June 7, 2001, if, before April 25, 2001, notice was provided to participants and beneficiaries adversely affected by the plan amendment (and their representatives) which was reasonably expected to notify them of the nature and effective date of the plan amendment. For purposes of this paragraph (a)(3)(ii), notice that complies with § 1.411(d)–6 of this chapter, as it appeared in the April 1, 2001, edition of 26 CFR part 1, is deemed to be notice which was reasonably expected to notify participants and beneficiaries adversely affected by the plan amendment (and their representatives) of the nature and effective date of the plan amendment.

(b) *Amendments taking effect prior to June 7, 2001*. For rules applicable to amendments taking effect prior to June 7, 2001, see § 1.411(d)–6 of this chapter, as it appeared in the April 1, 2001, edition of 26 CFR part 1.

(c) *Regulatory effective date*. Q&A–1 through Q&A–18 of this section apply to amendments taking effect on or after the date that is 120 days after publication of final regulations under this section (regulatory effective date).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 22, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 23, 2002, 67 F.R. 19713)

Partial Withdrawal of Previous Proposed Rules; Notice of Proposed Rulemaking and Notice of Public Hearing

Information Reporting for Qualified Tuition and Related Expenses; Magnetic Media Filing Requirements for Information Returns

REG–161424–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of previous proposed rules; notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document withdraws in part proposed regulations relating to the information reporting requirements under section 6050S. This document also contains new proposed regulations relating to the information reporting requirements under section 6050S for qualified tuition and related expenses. These proposed regulations reflect changes to the law made by the Taxpayer Relief Act of 1997 and the amendments made by the Internal Revenue Service Restructuring and Reform Act of 1998 and Public Law 107–131. The regulations provide guidance to eligible educational institutions that enroll any individual for any academic period. The regulations also provide guidance to insurers that make reimbursements or refunds of qualified tuition and related expenses. This document provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 29, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for August 13, 2002, at 10 a.m. must be received by July 23, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–161424–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–161424–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Taxpayers may also submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622–4910; concerning submissions of comments, the hearing and/or to be placed on the building access list to attend the hearing, Donna Poindexter, (202) 622–7180, and concerning the magnetic media filing specifications, waivers for filing on magnetic media, and extensions of time, contact the Internal Revenue Service, Martinsburg Computing Center, (304) 263–8700 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1678.

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

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

Background

1. *Summary*

This document withdraws § 1.6050S–1 of the notice of proposed rulemaking (REG–105316–98, 2000–2 C.B. 98) relating to the information reporting requirements under section 6050S that was published in the **Federal Register** (65 FR 37728) on June 16, 2000 (the 2000 proposed regulations). This document also contains new proposed amendments to 26 CFR part 1 in § 1.6050S–1 relating to information reporting requirements under section 6050S for eligible educational institutions and insurers (these proposed regulations). The IRS and the Treasury Department have determined that the 2000 proposed regulations addressing the information reporting requirements for payees who receive payments of interest on qualified education loans will be finalized in a separate Treasury decision.

2. *Effective Date of These Proposed Regulations and Reporting Requirements for the Calendar Year 2002*

The information reporting requirements in these proposed regulations are proposed to apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003, for amounts reportable for the calendar year 2003 and subsequent years. These proposed regulations will not be effective until they are finalized. Therefore, the information reporting requirements in Notice 97–73 (1997–2

C.B. 335), as modified, continue for information returns required to be filed, and information statements required to be furnished, for amounts reportable for the calendar year 2002 (for which the returns and statements are required to be filed and furnished in 2003). However, taxpayers may rely on these proposed regulations for guidance pending issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

3. *Current Statutory Provisions*

The Taxpayer Relief Act of 1997 (Public Law 105–34 (111 Stat. 788) (TRA '97)) added section 25A of the Internal Revenue Code (Code) to provide the Hope Scholarship Credit and the Lifetime Learning Credit (education tax credit). In general, the education tax credit allows certain taxpayers who pay qualified tuition and related expenses (qualified expenses) to an eligible educational institution (an institution) to claim a nonrefundable credit against their Federal income tax liability. On January 6, 1999, the IRS issued proposed regulations under section 25A. See 64 FR 794 (1999).

In addition, TRA '97 added section 6050S of the Code. Section 6050S was amended by the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206 (112 Stat. 685) (RRA '98)). In general, section 6050S requires eligible educational institutions who receive payments of qualified tuition and related expenses to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any education tax credit allowable under section 25A (as well as other tax benefits for higher education expenses). See H.R. Conf. Rept. No. 599, 105th Cong., 2d Sess., pp. 319–320 (1998).

In addition, section 6050S requires any person engaged in a trade or business of making payments to any individual under an insurance agreement as reimbursements or refunds of qualified tuition and related expenses (an insurer) to file information returns and to furnish written information statements. Lastly, section 6050S requires certain payees who receive payments of interest on one or more qualified education loans to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any interest deduction allowable under section 221.

As currently in effect, section 6050S(b) provides that the information return filed by an eligible educational institution or insurer must contain: (1) the name, address, and taxpayer identification number (TIN) of the individual with respect to whom payments were received, or the reimbursements or refunds were made, of qualified tuition and related expenses; (2) the name, address, and TIN of any individual certified by the individual as the taxpayer who will claim that individual as a dependent for purposes of the deduction allowable under section 151 for any taxable year ending with or within the year for which the information return is filed; (3) the aggregate amount of payments of qualified tuition and related expenses received by the eligible educational institution during the calendar year with respect to the individual; (4) the aggregate amount of reimbursements or refunds of qualified tuition and related expenses paid by an institution or an insurer during the calendar year with respect to the individual; (5) the aggregate amount of any scholarships or grants that the eligible educational institution processed during the calendar year for the individual's costs of attendance; and (6) such other information as the Secretary may prescribe.

4. *Previous Guidance Under Section 6050S*

The IRS has published several notices prescribing limited information reporting for eligible educational institutions for the years 1998, 1999, 2000, and 2001. See Notice 97–73 (1997–2 C.B. 335), Notice 98–46 (1998–2 C.B. 290), Notice 98–59 (1998–49 I.R.B. 16), Notice 99–37 (1999–2 C.B. 124), and Notice 2000–62 (2000–2 C.B. 587).

A notice of proposed rulemaking under section 6050S (REG–105316–98) was published in the **Federal Register** (65 FR 37728) on June 16, 2000. A public hearing was held on the proposed regulations on February 13, 2001. The IRS received written and electronic comments responding to the 2000 notice of proposed rulemaking.

5. *Recent Amendments to Section 6050S*

Section 6050S was further amended by Public Law 107–131 (115 Stat. 2410), effective for qualified expenses paid or billed after December 31, 2002, for academic periods beginning after December 31, 2002. For calendar years beginning after December 31, 2002, eligible educational institutions may elect to report either the aggregate amount of payments received, or the aggregate amount billed, for qualified tuition and related expenses during the calendar year with respect to individuals enrolled for any academic period. Institutions will no longer be required to report separately any refunds or reimbursements of qualified expenses made during the calendar year that relate to payments received for qualified expenses during the current calendar year. Rather, institutions will be required to report separately only adjustments made during the calendar year to payments received, or amounts billed, for qualified expenses that were reported in a prior calendar year. Institutions will be required to report scholarships or grants received for the individual's costs of attendance that the institution administered and processed during the calendar year. In addition, institutions will be required to report separately adjustments made during the calendar year to scholarships that were reported in a prior calendar year. Section 6050S will no longer require institutions to report the name, address, and TIN of any individual certified by the individual as the taxpayer who will claim that individual as a dependent for purposes of the deduction allowable under section 151 for any taxable year ending with or within the year for which the information return is filed.

These proposed regulations reflect the amendments to section 6050S by Public Law 107–131 and address many of the concerns raised by the educational community in their comments to the 2000 proposed regulations. These proposed regulations for eligible educational institutions and insurers are discussed below.

Explanation of Provisions

1. *Information Reporting Relating to Qualified Tuition and Related Expenses*

A. *Required reporting and exceptions to reporting*

Consistent with the amendments to section 6050S by Public Law 107–131, these proposed regulations require an eligible educational institution (as defined in section 25A(f)(2) and the regulations thereunder) (an institution) to file a Form 1098–T, *Tuition Payment Statement*, with respect to each individual who is or has been enrolled for any academic period (as defined in the regulations under section 25A) and for whom reportable transactions are made during the calendar year. In addition, these proposed regulations require any person engaged in a trade or business of making payments under an insurance arrangement as reimbursements or refunds (or other similar amounts) of qualified tuition and related expenses (as defined in section 25A(f)(1) and the regulations thereunder) (an insurer) to file a Form 1098–T with the IRS with respect to each individual for whom it makes reimbursements or refunds of qualified expenses.

(i) Reporting Based on Academic Year vs. Calendar Year

The commentators to the 2000 proposed regulations requested that an institution be allowed to report financial data based on an academic year, and not based on a calendar year. Section 6050S requires institutions to report on a calendar year in order to assist taxpayers in calculating the education tax credit that is allowable for qualified expenses paid during a calendar year. Therefore, these proposed regulations do not adopt this recommendation.

(ii) Eligible Educational Institution for Portion of Calendar Year

The commentators to the 2000 proposed regulations requested clarification of the rules for determining which institutions are required to report under section 6050S and the exceptions to reporting. One commentator asked whether an institution that is not an *eligible educational institution* within the meaning of section 25A(f)(2) at the beginning of the calendar year, but becomes an eligible educational institution during the calendar year, is required to report under section 6050S, and, if so, whether the institution must report for the entire calendar year or only the portion of the year in which it is an eligible educational institution. An institution that is an eligible educational institution for any portion of a calendar year must report under section 6050S. Further, because the education tax credit is allowable only for payments made to an eligible educational institution, the institution must report for only the portion of the year in which it is an eligible educational institution.

(iii) Exception for Nonresident Aliens

Several commentators to the 2000 proposed regulations requested clarification of the exception to reporting for an individual who is a nonresident alien. The 2000 proposed regulations provide that an institution or insurer must report for the year that the institution or insurer receives a request from a nonresident alien individual to report and all subsequent years. The commentators recommended that reporting be limited to the calendar year for which the institution or insurer receives the request. The commentators explained that institutions would need to create a new database to report automatically for subsequent years. These proposed regulations provide that any reporting for a nonresident alien individual is limited to the calendar year for which the institution or insurer receives a request.

(iv) Exception for Noncredit Courses

Several commentators to the 2000 proposed regulations requested clarification of the exception to reporting for an individual who is enrolled during the calendar year only in noncredit courses. The commentators noted that the exception is intended to cover students enrolled in courses for which no academic credit is offered, not students who do not receive academic credit in a particular course. Therefore, these proposed regulations clarify that the exception applies to students enrolled only in courses for which academic credit is not offered. In addition, several commentators suggested that the word "only" should be removed and that the exception should apply to students who are enrolled both in courses for which no academic credit is offered and in courses offered for credit that may lead toward a postsecondary degree. The exception is intended to cover nondegree students enrolled in courses for which no academic credit is offered, consistent with the legislative history to section 6050S. See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess., p. 322 (1998). Therefore, these proposed regulations do not adopt this recommendation.

Several commentators to the 2000 proposed regulations recommended that institutions should have discretion to define what constitutes *academic credit*. The 2000 proposed regulations define academic credit as credit awarded by an institution for the completion of coursework leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential. This definition provides a uniform test to determine academic credit for information reporting purposes. These proposed regulations retain the definition of academic credit and do not adopt this recommendation.

(v) No Exception for Small Institutions or Small Amounts of Qualified Tuition and Related Expenses

One commentator to the 2000 proposed regulations suggested that the regulations should provide an exception to reporting for institutions with 500 or fewer students, and another commentator suggested that the regulations should provide an exception for qualified expenses of $250 or less. The limited exceptions to required reporting are based on the fact that certain categories of students may not be eligible to claim the education tax credit (*e.g.*, nondegree students enrolled in noncredit courses cannot claim the Hope Scholarship Credit and nonresident alien students are generally not eligible to claim the education tax credit). See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess., p. 322 (1998). Exceptions to reporting for small institutions or small amounts of qualified expenses have no relationship to a student's eligibility to claim the education tax credit. Therefore, these proposed regulations do not adopt these recommendations.

(vi) Exception for Students Whose Qualified Expenses Are Paid with Scholarships

Several commentators to the 2000 proposed regulations suggested that the regulations should include an exception to reporting for students whose qualified expenses are waived in their entirety or are paid entirely with scholarships. Notice 97–73 provides that institutions are not required to report for such students because the institutions will not have received any payment of qualified expenses on behalf of such students for which the student could, in general, claim the education tax credit. These proposed regulations follow the rule in Notice 97–73 and provide that an institution is not required to report on students whose qualified expenses for the calendar year are waived in their entirety or are paid entirely with scholarships.

(vii) Exception for Students Whose Qualified Expenses Are Covered by Formal Billing Arrangement between Institution and Student's Employer

Several commentators to the 2000 proposed regulations suggested that the regulations should provide an exception to reporting for students whose qualified expenses are paid by a third party (such as an employer) to the institution through a formal billing arrangement. The commentators explained that often an employer and an institution enter into an agreement in which employees attend the institution, and the institution bills only the employer. In this situation, the institution does not maintain a separate account for each employee/student. These arrangements often constitute employer-provided educational assistance excludable from the employee's gross income under section 127. Under section 25A and the regulations thereunder, taxpayers cannot claim the education tax credit for education expenses paid by an employer which are tax-free to the employee. Therefore, these proposed regulations provide an exception to reporting with respect to any individual whose qualified expenses are covered by a formal billing arrangement between an institution and the individual's employer.

(viii) Family Educational Rights and Privacy Act and Optional Reporting

Several commentators to the 2000 proposed regulations requested clarification as to whether an institution that chooses to report on students otherwise covered by an exception to required reporting would violate the Family Educational Rights and Privacy Act (FERPA) (20 U.S.C. section 1232g). The Department of Education has previously determined that reporting under section 6050S does not violate FERPA. We have asked the Department of Education to consider whether this determination extends to institutions that choose to report on students otherwise covered by an exception to required reporting in these proposed regulations.

B. *Required information for institutions*

(i) Reporting of Payments Received vs. Amounts Billed

Based on the provisions of section 6050S prior to the amendments by Public Law 107–131, the 2000 proposed regulations provide that an institution must report the aggregate amount of payments received for qualified expenses, and the aggregate amount of reimbursements or refunds made of qualified expenses, with respect to any individual during the calendar year. Numerous commentators explained that their institutions cannot report payments for, and reimbursements or refunds of, qualified expenses, because their financial systems do not apply payments and reimbursements or refunds to specific charges. According to these institutions, a student's account is a running balance of undesignated payments and reimbursements or refunds. These commentators suggested that the regulations should allow institutions that are unable to report payments received for, and reimbursements or refunds made of, qualified expenses, to report instead: (1) the amount billed with respect to any individual for qualified expenses during the calendar year; and (2) the amount of any reductions to the amounts billed with respect to the individual.

Consistent with section 6050S as amended by Public Law 107–131, these proposed regulations provide that institutions may elect to report either the payments received, or the amounts billed, during the calendar year for qualified tuition and related expenses with respect to individuals enrolled for an academic period beginning during the calendar year or during a prior calendar year.

(ii) Reporting Adjustments to Payments Received (or Amounts Billed) for a Prior Calendar Year

The commentators to the 2000 proposed regulations suggested that the regulations should distinguish between reimbursements or refunds that relate to payments received during the current calendar year and those that relate to payments for prior calendar years. The commentators suggested that, rather than reporting separately aggregate payments and aggregate reimbursements or refunds, institutions should be permitted to net current year payments of qualified expenses against any refunds of such current year payments, and to report only the net payments received for qualified expenses during the current calendar year. These commentators suggested that institutions should be required to report separately only the amount of any reimbursements or refunds made in the current year that relate to qualified expenses paid that were reported in a prior calendar year.

Consistent with this approach, the commentators also suggested that institutions reporting amounts billed should be permitted to net amounts billed for qualified expenses for the current year against any reductions in amounts billed for qualified expenses for the current year, and to report only the net amount billed for qualified expenses during the current calendar year. Similarly, the commentators suggested that these institutions should be required to report separately only those reductions made in the current year that relate to amounts billed for qualified expenses that were reported in a prior calendar year.

Congress adopted this approach in the amendments to section 6050S by Public Law 107–131. As amended, section 6050S will require institutions to report separately only adjustments made during the calendar year to payments received, or amounts billed, that relate to amounts that were reported for a prior calendar year. For example, for institutions that report based on payments received, separate reporting will be required only for refunds or reimbursements of qualified expenses made during the calendar year that relate to payments of qualified expenses that were reported for a prior calendar year. For institutions that report based on amounts billed, separate reporting will be required only for reductions in charges made during the calendar year that relate to amounts billed for qualified expenses that were reported for a prior calendar year.

Therefore, for institutions that report based on payments received, these proposed regulations provide that, in determining the amounts to be reported under section 6050S for a calendar year, payments received for qualified expenses during the calendar year must be netted against any reimbursements or refunds of qualified expenses made during the calendar year that relate to payments received for qualified expenses during the same calendar year. These regulations also provide that reimbursements or refunds made during the calendar year that relate to payments of qualified expenses that were reported for a prior calendar year must be reported separately.

Similarly, for institutions that report based on amounts billed, these proposed regulations provide that, in determining the amounts to be reported under section 6050S for a calendar year, the amount billed for qualified expenses during the calendar year must be netted against any reductions in charges for qualified expenses made during the calendar year that relate to amounts billed for qualified expenses during the same calendar year. These regulations also provide that any reductions in charges made during the calendar year that relate to amounts reported as billed for a prior calendar year must be reported separately.

These regulations are proposed to apply to payments received, and amounts billed, for qualified expenses beginning in 2003. Therefore, the first year for which institutions may be required to collect information regarding any reimbursements or refunds of prior year reportable payments (or any reductions in reportable amounts billed for a prior year) is 2004. The amount of any reimbursements or refunds (or reductions) made in 2004 for amounts paid (or billed) in 2003 would be reported on the 2004 Forms 1098–T filed in early 2005.

(iii) Reporting Adjustments to Scholarships for a Prior Calendar Year

Consistent with section 6050S as amended by Public Law 107–131, these proposed regulations provide that all institutions must report separately any reductions in the amount of scholarships or grant aid reported for a prior calendar year.

(iv) Name, Address, and TIN of Taxpayer

The 2000 proposed regulations reserve the requirement in section 6050S(b)(2)(B) that an institution or insurer obtain and report the name, address, and TIN of any taxpayer who will claim the individual as a dependent for purposes of the deduction allowable under section 151 for the taxable year. This statutory requirement will be eliminated by the amendments to section 6050S by Public Law 107–131. Therefore, consistent with section 6050S as amended, these proposed regulations remove this requirement.

(v) Half-time Indicator

Several commentators to the 2000 proposed regulations suggested that institutions should not be required to indicate whether a student was enrolled at least half time. Another commentator suggested that institutions should be required to provide the half-time indicator only for students enrolled in undergraduate studies. An indication as to whether a student was enrolled at least half time for one academic period is useful information for the IRS to verify whether the student may be eligible to claim the Hope Scholarship Credit and certain other education tax benefits, and this information is readily available to institutions. Therefore, these proposed regulations do not adopt these recommendations.

(vi) Information Statement

The 2000 proposed regulations provide that an institution or insurer must furnish an information statement to each individual for whom it is required to file a Form 1098–T. The statement must include specific instructions to the taxpayer. These proposed regulations provide that the instructions must state that a taxpayer may claim an education tax credit only for amounts actually paid during the calendar year. These proposed regulations also provide that the instructions must state that the amount of any refunds or reimbursements of payments received, or reductions in charges, for qualified expenses or any reductions in grant aid reported for a prior calendar year may affect the amount of any education tax credit allowable for the prior calendar year.

The 2000 proposed regulations provide that the statement must include the name, address, and phone number of the individual who is the information contact for the institution or insurer that filed the Form 1098–T. Several commentators to the 2000 proposed regulations requested that the regulations should not require the name of an individual. The commentators explained that it is not feasible for institutions to provide an individual as the information contact and requested that institutions be allowed to provide an office or department of the institution as the information contact. These proposed regulations adopt this recommendation.

The 2000 proposed regulations reserve the requirement in section 6050S(d) that an institution or insurer furnish a statement to any taxpayer who will claim the individual as a dependent for purposes of the deduction allowable under section 151 for the taxable year. This statutory requirement will be eliminated by the amendments to section 6050S by Public Law 107–131. Therefore, consistent with section 6050S as amended, these regulations remove this requirement.

C. *Required information for insurers*

The information reporting requirements for insurers is not changed by the amendments to section 6050S by Public Law 107–131. Therefore, these proposed regulations continue to provide that an insurer must file an information return for each individual with respect to whom reimbursements or refunds of qualified tuition and related expenses are made during the calendar year. An insurer must include: (1) the name, address, and TIN of the insurer; (2) the name, address, and TIN of the individual with respect to whom reimbursements or refunds of qualified tuition and related expenses were made; and (3) the aggregate amount of reimbursements or refunds of qualified tuition and related expenses that the insurer made with respect to the individual during the calendar year.

D. *Information reporting penalties*

(i) Penalty Notification

These proposed regulations, as well as the 2000 proposed regulations, provide that an institution or insurer may be subject to a penalty under section 6721 for failure to file correct Forms 1098–T and a penalty under section 6722 for failure to furnish correct information statements. The 2000 proposed regulations provide that an institution or insurer must notify the individual that the IRS may impose a $50 penalty for failure to provide a TIN. Several commentators to the 2000 proposed regulations requested that the penalty notification be removed. Section 6723 and the regulations thereunder authorize the IRS to impose a $50 penalty if an individual fails to provide his or her TIN as required but do not require an institution or insurer to give prior notification of the penalty. Therefore, these proposed regulations adopt this recommendation.

(ii) Annual TIN Solicitation Requirement

Several commentators to the 2000 proposed regulations recommended that institutions not be required to request an individual's TIN annually if the institution does not have the individual's TIN. These proposed regulations continue to provide that, in order to establish a waiver of the information reporting penalties for reasonable cause, an institution or insurer must request an individual's TIN annually if it does not have the TIN. The annual solicitation rule in these regulations is consistent with the general solicitation requirements in section 301.6724–1(e) and (f) that a filer must meet in order to establish reasonable cause. These proposed regulations clarify that a separate solicitation is not necessary if an institution requests an individual's TIN through admission or enrollment forms or financial aid applications.

(iii) Filing Information Returns with Missing TINs

Several commentators to the 2000 proposed regulations requested that institutions not be required to file information returns and to furnish information statements for individuals who refuse to provide their TINs. Information returns and information statements with missing TINs are useful to both the IRS and the individual in verifying the amount of any allowable education tax credit (as well as other tax benefits for higher education expenses). Therefore, these proposed regulations do not adopt this recommendation.

2. *Requirement to File Information Returns on Magnetic Media*

These regulations propose to amend the regulations under section 6011(e) to require institutions and insurers who are required to file 250 or more Forms 1098–T to file on magnetic media.

Special Analyses

It has been determined that these proposed regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. An initial regulatory flexibility analysis has been prepared for this notice of proposed rulemaking under section 5 U.S.C. 603 and is set forth under the heading "Initial Regulatory Flexibility Analysis" in this preamble. 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.

Initial Regulatory Flexibility Analysis

The collection of information contained in § 1.6050S–1 is needed to assist the IRS and taxpayers in determining the amount of any education tax credit allowable under section 25A. The objectives of these regulations are to provide uniform, practicable, and administrable rules under section 6050S. The types of small entities to which the regulations may apply are small eligible educational institutions (such as colleges and universities) and certain insurers who reimburse educational expenses. As of the end of 2001, a total of 19,817,563 Forms 1098–T were filed with the IRS for 2000. The estimated reporting burden for 2001 is 9 minutes per Form 1098–T. No special professional skills are necessary for preparation of the reports or records. There are no known Federal rules that duplicate, overlap, or conflict with these proposed regulations. The regulations proposed are considered to have the least economic impact on small entities of all alternatives considered.

Moreover, the proposed regulations requiring filing Forms 1098–T on magnetic media impose no additional reporting or recordkeeping and only prescribe the method of filing information returns that are already required to be filed. Further, these regulations are consistent with the statutory requirement that an institution or insurer is not required to file Forms 1098–T on magnetic media unless required to file at least 250 or more returns during the year. Finally, the economic impact caused by requiring Forms 1098–T on magnetic media should be minimal because most institution's or insurer's operations are computerized. Even if their operations are not computerized, the incremental cost of magnetic media reporting should be minimal in most cases because of the availability of computer service bureaus. In addition, the existing regulations under section 6011(e) provide that the IRS may waive the magnetic media filing requirements on a showing of hardship. The waiver authority will be exercised so as not to unduly burden institutions and insurers lacking both the necessary data processing facilities and access at a reasonable cost to computer service bureaus.

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 13, 2002, beginning at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. 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 or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by July 23, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of the regulations is Donna Welch, Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1—INCOME TAX

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

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

Section 1.6050S–1 also issued under section 26 U.S.C. 6050S(g). * * *

Par. 2. Sections 1.6050S–0 is amended by revising the introductory language and adding new entries for § 1.6050S–1 to read as follows:

§ 1.6050S–0 Table of contents

This section lists captions contained in §§ 1.6050S–1, 1.6050S–2T, 1.6050S–3, and 1.6050S–4T.

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(f) Effective date.

* * * * *

Par. 3. Section 1.6050S–1 is added to read as follows:

§ 1.6050S–1 Information reporting for qualified tuition and related expenses.

(a) *Information reporting requirement*—(1) *In general*. Except as provided in paragraph (a)(2) of this section, any eligible educational institution (as defined in section 25A(f)(2) and the regulations thereunder) (an institution) that enrolls (as determined under paragraph (d)(1) of this section) any individual for any academic period (as defined in the regulations under section 25A), and any person that is engaged in a trade or business of making payments under an insurance arrangement as reimbursements or refunds (or other similar amounts) of qualified tuition and related expenses (as defined in section 25A(f)(1) and the regulations thereunder) (an insurer) must—

(i) File an information return, as described in paragraph (b) of this section, with the Internal Revenue Service (IRS) with respect to each individual described in paragraph (b) of this section; and

(ii) Furnish a statement, as described in paragraph (c) of this section, to each individual described in paragraph (c) of this section.

(2) *Exceptions*—(i) *No reporting by institution or insurer for nonresident alien individuals*. The information reporting requirements of this section do not apply with respect to any individual who is a nonresident alien (as defined in section 7701(b) and § 301.7701(b)–3 of this chapter) during the calendar year, unless the individual requests the institution or insurer to report. If a nonresident alien individual requests an institution or insurer to report, the institution or insurer must comply with the requirements of this section for the calendar year with respect to which the request is made.

(ii) *No reporting by institutions for individuals enrolled only in noncredit courses*—(A) *In general*. The information reporting requirements of this section do not apply with respect to any individual who is enrolled during the calendar year only in courses for which no academic credit is offered by the institution.

(B) *Academic credit defined*. *Academic credit* means credit offered by an institution for the completion of coursework leading toward a post-secondary degree, certificate, or other recognized post-secondary educational credential.

(C) *Example*. The following example illustrates the rules of this paragraph (a)(2)(ii):

Example. Student A, a medical doctor, takes a course at University X's medical school. Student A takes the course to fulfill State Y's licensing requirement that medical doctors attend continuing medical education courses each year. Student A is not enrolled in a degree program at University X and takes the medical course through University X's continuing professional education division. University X does not offer Student A credit toward a post-secondary degree on an academic transcript for the completion of the course but gives Student A a certificate of attendance upon completion. Under this paragraph (a)(2)(ii), University X is not subject to the information reporting requirements of section 6050S and this section for the medical education course taken by Student A.

(iii) *No reporting by institutions for individuals whose qualified tuition and related expenses are waived or are paid with scholarships*. The information reporting requirements of this section do not apply with respect to any individual whose qualified tuition and related expenses are waived in their entirety or are paid entirely with scholarships.

(iv) *No reporting by institutions for individuals whose qualified tuition and related expenses are covered by a formal billing arrangement*—(A) *In general*. The information reporting requirements of this section do not apply with respect to any individual whose qualified tuition and related expenses are covered by a formal billing arrangement between an institution and the individual's employer.

(B) *Formal billing arrangement defined*. A *formal billing arrangement* means an arrangement in which the institution bills only the employer for education furnished by the institution to an individual who is the employer's employee and the institution does not maintain a separate financial account for that individual.

(b) *Requirement to file return*—(1) *In general*. Institutions may elect to report either the information described in paragraph (b)(2) of this section, or the information described in paragraph (b)(3) of this section. Once an institution elects to report under either paragraph (b)(2) or (3) of this section, the institution must use the same reporting method for all calendar years in which it is required to file returns, unless permission is granted to change reporting methods. Paragraph (b)(2) requires institutions to report, among other information, the amount of payments received during the calendar year for qualified tuition and related expenses. Institutions must report separately adjustments made during the calendar year that relate to payments received for qualified tuition and related expenses that were reported for a prior calendar year. For purposes of paragraph (b)(2), an adjustment made to payments received means a reimbursement or refund. Paragraph (b)(3) requires institutions to report, among other information, the amounts billed during the calendar year for qualified tuition and related expenses. Institutions must report separately adjustments made during the calendar year that relate to amounts billed for qualified tuition and related expenses that were reported for a prior calendar year. For purposes of paragraph (b)(3), an adjustment made to amounts billed means a reduction in charges. Insurers must report the information described in paragraph (b)(4) of this section.

(2) *Information reporting requirements for institutions that elect to report payments received for qualified tuition and related expenses*—(i) *In general*. Except as provided in paragraph (a)(2) of this section, an institution reporting payments received for qualified tuition and related expenses must file an information return with the IRS on Form 1098–T, *Tuition Payments Statement*, with respect to each individual enrolled (as determined in paragraph (d)(1) of this section) for an academic period beginning during the calendar year or during a prior calendar year and for whom a reportable transaction described in paragraph (b)(2)(ii) of this section is made during the calendar year. An institution may use a substitute Form 1098–T if the substitute form complies with applicable revenue procedures relating to substitute forms (see § 601.601(d)(2) of this chapter).

(ii) *Information included on return*. An institution reporting payments received for qualified tuition and related expenses must include on Form 1098–T—

(A) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the institution;

(B) The name, address, and TIN of the individual who is, or has been, enrolled by the institution;

(C) The amount of payments of qualified tuition and related expenses from any source that the institution received with respect to the individual during the calendar year;

(D) An indication by the institution whether any payments received for qualified tuition and related expenses reported for the calendar year relate to an academic period that begins during the first three months of the next calendar year;

(E) The amount of any scholarships or grants for the payment of the individual's costs of attendance that the institution administered and processed during the calendar year;

(F) The amount of any reimbursements or refunds of qualified tuition and related expenses made during the calendar year with respect to the individual that relate to payments of qualified tuition and related expenses that were reported by the institution for a prior calendar year;

(G) The amount of any reductions to the amount of scholarships or grants for the payment of the individual's costs of attendance that were reported by the institution with respect to the individual for a prior calendar year;

(H) An indication by the institution whether the individual was enrolled for at least half of the normal full-time work load for the course of study the individual is pursuing for at least one academic period that begins during the calendar year (see section 25A and the regulations thereunder);

(I) An indication by the institution whether the individual was enrolled in a program leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential; and

(J) Any other information required by Form 1098–T and its instructions.

(iii) *Reportable amount of payments received for qualified tuition and related expenses during calendar year determined*. The amount of payments received for qualified tuition and related expenses with respect to an individual during the calendar year that is reportable on Form 1098–T is determined by netting the amount of payments received (as defined in paragraph (b)(2)(v) of this section) for qualified tuition and related expenses during the calendar year against any reimbursements or refunds (as defined in paragraph (b)(2)(vi) of this section) made during the calendar year that relate to payments received for qualified tuition and related expenses during the same calendar year.

(iv) *Separate reporting of reimbursements or refunds of payments of qualified tuition and related expenses that were reported for a prior calendar year*. An institution must separately report on Form 1098–T any reimbursements or refunds (as defined in paragraph (b)(2)(vi) of this section) made during the current calendar year that relate to payments of qualified tuition and related expenses that were reported by the institution for a prior calendar year. Such reimbursements or refunds shall not be netted against the payments received for qualified tuition and related expenses during the current calendar year.

(v) *Payments received for qualified tuition and related expenses determined*. For purposes of determining the amount of payments received for qualified tuition and related expenses during a calendar year, payments received with respect to an individual during the calendar year from any source (except for any scholarship or grant that, by its terms, must be applied to expenses other than qualified tuition and related expenses, such as room and board) are treated as payments of qualified tuition and related expenses up to the total amount billed by the institution for such expenses. For purposes of this section, a payment includes any positive account balance (such as any reimbursement or refund credited to an individual's account) that an institution applies toward current charges.

(vi) *Reimbursements or refunds of payments for qualified tuition and related expenses determined*. For purposes of determining the amount of reimbursements or refunds made of payments received for qualified tuition and related expenses, any reimbursement or refund made with respect to an individual during a calendar year (except for any refund of scholarship or grant that, by its terms, was required to be applied to expenses other than qualified tuition and related expenses, such as room and board), is treated as a reimbursement or refund of payments for qualified tuition and related expenses up to the amount of any reduction in charges for such expenses. For purposes of this section, a reimbursement or refund includes amounts that an institution credits to an individual's account, as well as amounts disbursed to, or on behalf of, the individual.

(vii) *Examples*. The following examples illustrate the rules in this paragraph (b)(2):

Example 1. (i) In early August 2003, University X bills enrolled Student A $10,000 for tuition and $6,000 for room and board for the 2003 Fall semester. In late August 2003, Student A pays $11,000 to University X. In early September 2003, Student A drops to half-time enrollment for the 2003 Fall semester. In late September 2003, University X credits $5,000 to Student A's account, reflecting a $5,000 reduction in charges for qualified tuition and related expenses. In late September 2003, University X applies the $5,000 positive account balance toward current charges.

(ii) Under paragraph (b)(2)(v) of this section, the $11,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(vi) of this section, the $5,000 credited to the student's account is treated as a reimbursement or refund of payments for qualified tuition and related expenses, because the current year charges for qualified tuition and related expenses were reduced by $5,000. Under paragraph (b)(2)(iii) of this section, University X is required to net the $10,000 tuition payment received during 2003 against the $5,000 reimbursement or refund of payments received for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 of payments received for qualified tuition and related expenses during 2003.

Example 2. (i) The facts are the same as in *Example 1*, except that Student A pays the full $16,000 in late August 2003. In late September 2003, University X reduces the tuition charges by $5,000 and issues a $5,000 refund to Student A.

(ii) Under paragraph (b)(2)(v) of this section, the $16,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(vi) of this section, the $5,000 refund is treated as reimbursement or refund of payments for qualified tuition and related expenses, because the current year charges for qualified tuition and related expenses were reduced by $5,000. Under paragraph (b)(2)(iii) of this section, University X is required to net the $10,000 tuition payment received during 2003 against the $5,000 reimbursement or refund of payments received for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 of payments received for qualified tuition and related expenses during 2003.

Example 3. (i) The facts are the same as in *Example 1*, except that Student A is enrolled full-time, and, in early September 2003, Student A decides to live at home with her parents. In late September 2003, University X adjusts Student A's account to eliminate room and board charges and issues a $1,000 refund to Student A.

(ii) Under paragraph (b)(2)(v) of this section, the $11,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(vi) of this section, the

$1,000 refund is not treated as reimbursement or refund of payments for qualified tuition and related expenses, because there is no reduction in charges for qualified tuition and related expenses. Therefore, under paragraph (b)(2)(iii) of this section, University X is required to report $10,000 of payments received for qualified tuition and related expenses during 2003.

Example 4. (i) In early December 2003, College Y bills enrolled Student B $10,000 for tuition and $6,000 for room and board for the 2004 Spring semester. In late December 2003, Student B pays $16,000. In mid-January 2004, after the 2004 Spring semester classes begin, Student B drops to half-time enrollment. In mid-January 2004, College Y credits Student B's account with $5,000, reflecting a $5,000 reduction in charges for qualified tuition and related expenses, but does not issue a refund to Student B. In early August 2004, College Y bills Student B $10,000 for tuition and $6,000 for room and board for the 2004 Fall semester. In early September 2004, College Y applies the $5,000 positive account balance toward Student B's $16,000 bill for the 2004 Fall semester. In late September 2004, Student B pays $6,000 towards the charges.

(ii) Reporting for calendar year 2003. Under paragraph (b)(2)(v) of this section, the $16,000 payment in December 2003 is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(iii) of this section, College Y is required to report $10,000 of payments received for qualified tuition and related expenses during 2003. In addition, College Y is required to indicate that the payments reported for 2003 relate to an academic period that begins during the first three months of the next calendar year.

(iii) Reporting for calendar year 2004. Under paragraph (b)(2)(vi) of this section, the $5,000 credited to Student B's account is treated as a reimbursement or refund of qualified tuition and related expenses, because the charges for qualified tuition and related expenses were reduced by $5,000. Under paragraph (b)(2)(iv) of this section, the $5,000 reimbursement or refund of qualified tuition and related expenses must be separately reported on Form 1098–T because it relates to payments of qualified tuition and related expenses reported by College Y for 2003. Under paragraph (b)(2)(v) of this section, the $5,000 positive account balance that is applied toward charges for the 2004 Fall semester is treated as a payment. Therefore, College Y received total payments of $11,000 during 2004 (the $5,000 credit plus the $6,000 payment). Under paragraph (b)(2)(v) of this section, the $11,000 of total payments are treated as a payment of qualified tuition and related expenses up to the $10,000 billed for such expenses. Therefore, for 2004, College Y is required to report $10,000 of payments received for qualified tuition and related expenses during 2004 and a $5,000 refund of payments of qualified tuition and related expenses reported for 2003.

(3) *Information reporting requirements for institutions that elect to report amounts billed for qualified tuition and related expenses*—(i) *In general*. Except as provided in paragraph (a)(2) of this section, an institution reporting amounts billed for qualified tuition and related expenses must file an information return on Form 1098–T with respect to each individual enrolled (as determined in paragraph (d)(1) of this section) for an academic period beginning during the calendar year or during a prior calendar year and for whom a reportable transaction described in paragraph (b)(3)(ii) of this section is made during the calendar year. An institution may use a substitute Form 1098–T if the substitute form complies with applicable revenue procedures relating to substitute forms.

(ii) *Information included on return*. An institution reporting amounts billed for qualified tuition and related expenses must include on Form 1098–T—

(A) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the institution;

(B) The name, address, and TIN of the individual who is, or has been, enrolled by the institution;

(C) The amount billed for qualified tuition and related expenses with respect to the individual during the calendar year;

(D) An indication by the institution whether any amounts billed for qualified tuition and related expenses reported for the calendar year relate to an academic period that begins during the first three months of the next calendar year;

(E) The amount of any scholarships or grants for the payment of the individual's costs of attendance that the institution administered and processed during the calendar year;

(F) The amount of any reductions in charges made during the calendar year with respect to the individual that relate to amounts billed for qualified tuition and related expenses that were reported by the institution for a prior calendar year;

(G) The amount of any reductions to the amount of scholarships or grants for the payment of the individual's costs of attendance that were reported by the institution with respect to the individual for a prior calendar year;

(H) An indication by the institution whether the individual was enrolled for at least half of the normal full-time work load for the course of study the individual is pursuing for at least one academic period that begins during the calendar year (see section 25A and the regulations thereunder);

(I) An indication by the institution whether the individual was enrolled in a program leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential; and

(J) Any other information required by Form 1098–T and its instructions.

(iii) *Reportable amounts billed for qualified tuition and related expenses during calendar year determined*. The amount billed for qualified tuition and related expenses with respect to an individual during the calendar year that is reportable on Form 1098–T is determined by netting the amounts billed for qualified tuition and related expenses during the calendar year against any reductions in charges for qualified tuition and related expenses made during the calendar year that relate to amounts billed for qualified tuition and related expenses during the same calendar year.

(iv) *Separate reporting of reductions made to amounts billed for qualified tuition and related expenses that were reported for a prior calendar year*. An institution must separately report on Form 1098–T any reductions in charges made during the current calendar year that relate to amounts billed for qualified tuition and related expenses that were reported by the institution for a prior calendar year. Such reductions shall not be netted against amounts billed for qualified tuition and related expenses during the current calendar year.

(v) *Examples*. The following examples illustrate the rules in this paragraph (b)(3):

Example 1. (i) In early August 2003, University X bills enrolled Student A $10,000 for tuition and $6,000 for room and board for the 2003 Fall semester. In late August 2003, Student A pays $11,000 to University X. In early September 2003, Student A drops to half-time enrollment for the 2003 Fall semester. In late September 2003, University X adjusts Student A's account and reduces the tuition charges by $5,000 to reflect half-time enrollment. In late September 2003, University X applies the $5,000 account balance toward current charges.

(ii) Under paragraph (b)(3)(iii) of this section, University X is required to net the $10,000 amount of tuition billed during 2003 against the $5,000 reduction in charges for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 in amounts billed for qualified tuition and related expenses during 2003.

Example 2. (i) The facts are the same as in *Example 1*, except that, in addition, in early December 2003, College X bills Student A $10,000 for tuition and $6,000 for room and board for the 2004

Spring semester. In late December 2003, Student A pays $16,000. In mid-January 2004, after the 2004 Spring semester classes begin, Student A drops to half-time enrollment. In mid-January 2004, College X credits $5,000 to Student A's account, reflecting a $5,000 reduction in charges for qualified tuition and related expenses, but does not issue a refund check to Student A. In early August 2004, College X bills Student A $10,000 for tuition and $6,000 for room and board for the 2004 Fall semester. In early September 2004, College X applies the $5,000 positive account balance toward Student A's $16,000 bill for the 2004 Fall semester. In late September 2004, Student A pays $6,000 toward the charges.

(ii) Reporting for calendar year 2003. Under paragraph (b)(3)(iii) of this section, College X is required to report $15,000 amounts billed for qualified tuition and related expenses during 2003 ($5,000 for the 2003 Fall semester and $10,000 for the 2004 Spring semester). In addition, College X is required to indicate that some of the amounts billed for qualified tuition and related expenses reported for 2003 relate to an academic period that begins during the first three months of the next calendar year.

(iii) Reporting for calendar year 2004. Under paragraph (b)(3)(iv) of this section, the $5,000 reduction in charges for qualified tuition and related expenses must be separately reported on Form 1098–T because it relates to amounts billed for qualified tuition and related expenses that were reported by College X for 2003. Under paragraph (b)(3)(iii) of this section, College X is required to report $10,000 in amounts billed for qualified tuition and related expenses during 2004.

(4) *Requirements for insurers*—(i) *In general*. Except as otherwise provided in this section, an insurer must file an information return for each individual with respect to whom reimbursements or refunds of qualified tuition and related expenses are made during the calendar year on Form 1098–T. An insurer may use a substitute Form 1098–T if the substitute form complies with applicable revenue procedures relating to substitute forms (see § 601.601(d)(2) of this chapter).

(ii) *Information included on return*. An insurer must include on Form 1098–T—

(A) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the insurer;

(B) The name, address, and TIN of the individual with respect to whom reimbursements or refunds of qualified tuition and related expenses were made;

(C) The aggregate amount of reimbursements or refunds of qualified tuition and related expenses that the insurer made with respect to the individual during the calendar year; and

(D) Any other information required by Form 1098–T and its instructions.

(5) *Time and place for filing return*—(i) *In general*. Except as provided in paragraphs (b)(5)(ii) and (iii) of this section, Form 1098–T must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which payments were received, or amounts were billed, for qualified tuition or related expenses, or reimbursements, refunds, or reductions of such amounts were made. An institution or insurer must file Form 1098–T with the IRS according to the instructions to Form 1098–T.

(ii) *Return for nonresident alien individual*. In general, an institution or insurer is not required to file a return on behalf of a nonresident alien individual. However, if a nonresident alien individual requests an institution or insurer to report, the institution or insurer must file a return described in paragraph (b) of this section with the IRS on or before the date prescribed in paragraph (b)(5)(i) of this section, or on or before the thirtieth day after the request, whichever is later.

(iii) *Extensions of time*. The IRS may grant an institution or insurer an extension of time to file returns required in this section upon a showing of good cause. See the instructions to Form 1098–T and applicable revenue procedures for rules relating to extensions of time to file (see § 601.601(d)(2) of this chapter).

(6) *Use of magnetic media*. See section 6011(e) and § 301.6011–2 of this chapter for rules relating to the requirement to file Forms 1098–T on magnetic media.

(c) *Requirement to furnish statement*—(1) *In general*. An institution or insurer must furnish a statement to each individual for whom it is required to file a Form 1098–T. The statement must include—

(i) The information required under paragraph (b) of this section;

(ii) A legend that identifies the statement as important tax information that is being furnished to the IRS;

(iii) Instructions that—

(A) State that the statement reports either total payments received by the institution for qualified tuition and related expenses during the calendar year, or total amounts billed by the institution for qualified tuition and related expenses during the calendar year, or the total reimbursements or refunds made by the insurer;

(B) State that, under section 25A and the regulations thereunder, the taxpayer may claim an education tax credit only with respect to qualified tuition and related expenses actually paid during the calendar year; and that the taxpayer may not be able to claim an education tax credit with respect to the entire amount of payments received, or amounts billed, for qualified tuition and related expenses reported for the calendar year;

(C) State that the amount of any scholarships or grants reported for the calendar year and other similar amounts not reported (because they are not administered and processed by the institution) may reduce the amount of any allowable education tax credit for the taxable year;

(D) State that the amount of any reimbursements or refunds of payments received, or reductions in charges, for qualified tuition and related expenses, or any reductions to the amount of scholarships or grants, reported by the institution with respect to the individual for a prior calendar year may affect the amount of any allowable education tax credit for the prior calendar year;

(E) State that the amount of any reimbursements or refunds of qualified tuition and related expenses reported by an insurer may reduce the amount of an allowable education tax credit for a taxable year;

(F) State that the taxpayer should refer to relevant IRS forms and publications, and should not refer to the institution or the insurer, for explanations relating to the eligibility requirements for, and calculation of, any allowable education tax credit; and

(G) Include the name, address, and phone number of the office or department within the institution or insurer that is the information contact for the institution or insurer that filed the Form 1098–T.

(2) *Time and manner for furnishing statement*—(i) *In general*. Except as provided in paragraphs (c)(2)(ii) and (iii) of this section, an institution or insurer must furnish the statement described in paragraph (c)(1) of this section to each individual for whom it is required to file a return, on or before January 31 of the year following the calendar year in which payments were received, or amounts were billed, for qualified tuition and related expenses, or reimbursements, refunds, or

reductions of such amounts were made. If mailed, the statement must be sent to the individual's permanent address, or the individual's temporary address if the institution or insurer does not know the individual's permanent address. If furnished electronically, the statement must be furnished in accordance with the applicable regulations.

(ii) *Statement to nonresident alien individual*. If an information return is filed for a nonresident alien individual, the institution or insurer must furnish a statement described in paragraph (c)(1) of this section to the individual in the manner and on or before the date prescribed in paragraph (c)(2)(i) of this section, or on or before the thirtieth day after the nonresident alien's request to report, whichever is later.

(iii) *Extensions of time*. The IRS may grant an institution or insurer an extension of time to furnish the statements required in this section upon a showing of good cause. See the instructions to Form 1098–T and applicable revenue procedures for rules relating to extensions of time to furnish statements (see § 601.601(d)(2) of this chapter).

(3) *Copy of Form 1098–T*. An institution or insurer may satisfy the requirement of this paragraph (c) by furnishing either a copy of Form 1098–T and its instructions or another document that contains all of the information filed with the IRS and the information required by paragraph (c)(1) of this section if the document complies with applicable revenue procedures relating to substitute statements (see § 601.601(d)(2) of this chapter).

(d) *Special rules*—(1) *Enrollment determined*. An institution may determine its enrollment for each academic period under its own rules and policies for determining enrollment or as of any of the following dates—

(i) 30 days after the first day of the academic period;

(ii) A date during the academic period on which enrollment data must be collected for purposes of the Integrated Post Secondary Education Data System administered by the Department of Education; or

(iii) A date during the academic period on which the institution must report enrollment data to the State, the institution's governing body, or some other external governing body.

(2) *Payments of qualified tuition and related expenses received or collected by one or more persons*—(i) *In general*. Except as otherwise provided in paragraph (d)(2)(ii) of this section, if a person collects or receives payments of qualified tuition and related expenses on behalf of another person (*e.g.*, an institution), the person collecting or receiving payments must satisfy the information reporting requirements of this section. In this case, the reporting requirements do not apply to the transfer of the payments to the institution.

(ii) *Exception*. If the person collecting or receiving payments of qualified tuition and related expenses on behalf of another person (*e.g.*, an institution) does not possess the information needed to comply with the information reporting requirements of this section, the other person must satisfy the information reporting requirements of this section.

(3) *Governmental units*. An institution or insurer that is a governmental unit, or an agency or instrumentality of a governmental unit, is subject to the information reporting requirements of this section and an appropriately designated officer or employee of the governmental entity must satisfy the information reporting requirements of this section.

(e) *Penalty provisions*—(1) *Failure to file correct returns*. The section 6721 penalty may apply to an institution or insurer that fails to file information returns required by section 6050S and this section on or before the required filing date; that fails to include all of the required information on the return; or that includes incorrect information on the return. See section 6721, and the regulations thereunder, for rules relating to penalties for failure to file correct returns. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(2) *Failure to furnish correct information statements*. The section 6722 penalty may apply to an institution or insurer that fails to furnish statements required by section 6050S and this section on or before the prescribed date; that fails to include all the required information on the statement; or that includes incorrect information on the statement. See section 6722, and the regulations thereunder, for rules relating to penalties for failure to furnish correct statements. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(3) *Waiver of penalties for failures to include a correct TIN*—(i) *In general*. In the case of a failure to include a correct TIN on Form 1098–T or a related information statement, penalties may be waived if the failure is due to reasonable cause. Reasonable cause may be established if the failure arose from events beyond the institution's or insurer's control, such as a failure of the individual to furnish a correct TIN. However, the institution or insurer must establish that it acted in a responsible manner both before and after the failure.

(ii) *Acting in a responsible manner*. An institution or insurer must request the TIN of each individual for whom it is required to file a return if it does not already have a record of the individual's correct TIN. If the institution or insurer does not have a record of the individual's correct TIN, then it must solicit the TIN in the manner described in paragraph (e)(3)(iii) of this section on or before December 31 of each year during which it receives payments, or bills amounts, for qualified tuition and related expenses or makes reimbursements, refunds, or reductions of such amounts with respect to the individual. If an individual refuses to provide his or her TIN upon request, the institution or insurer must file the return and furnish the statement required by this section without the individual's TIN, but with all other required information. The specific solicitation requirements of paragraph (e)(3)(iii) of this section apply in lieu of the solicitation requirements of § 301.6724–1(e) and (f) of this chapter for the purpose of determining whether an institution or insurer acted in a responsible manner in attempting to obtain a correct TIN. An institution or insurer that complies with the requirements of this paragraph (e)(3) will be considered to have acted in a responsible manner within the meaning of § 301.6724–1(d) of this chapter with respect to any failure to include the correct TIN of an individual on a return or statement required by section 6050S and this section.

(iii) *Manner of soliciting TIN*. An institution or insurer must request the individual's TIN in writing and must clearly notify the individual that the law requires the individual to furnish a TIN so that it may be included on an information return filed by the institution or insurer. A request for a TIN made on Form W–9S, *Request for Student's or Borrower's Social Security Number and Certification*, satisfies the requirements of this paragraph (e)(3)(iii). An institution or insurer may establish a system for individuals to submit Forms W–9S electronically as described in applicable forms and instructions. An institution or insurer may also develop a separate form to request the individual's TIN or incorporate the request into other forms customarily used by the institution or insurer, such as admission or enrollment forms or financial aid applications.

(4) *Failure to furnish TIN*. The section 6723 penalty may apply to any individual who is required (but fails) to furnish his or her TIN to an institution or insurer. See section 6723, and the regulations thereunder, for rules relating to the penalty for failure to furnish a TIN.

(f) *Effective date*. The rules in this section apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Par. 5. Section 301.6011–2 is amended by:

1. In paragraph (b)(1), first sentence, add the language "1098–T," immediately after the language "1098–E,".

2. Revising paragraph (g)(3).

The revision reads as follows:

§ 301.6011–2 Required use of magnetic media.

* * * * *

(g) * * *

(3) This section applies to returns on Forms 1098–E and 1098–T filed after December 31, 2003.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 26, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 29, 2002, 67 F.R. 20923)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as"rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified,* below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified,* above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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