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Title 26—Internal Revenue

(This book contains parts 50 to 299)

Part

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CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY (CONTINUED)

EDITORIAL NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980.

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SUPPLEMENTARY PUBLICATIONS: *Internal Revenue Service Looseleaf Regulations System.*

Additional supplementary publications are issued covering *Alcohol, Tobacco and Firearms Regulations,* and *Regulations Under Tax Conventions.*

SUBCHAPTER D—MISCELLANEOUS EXCISE TAXES (CONTINUED)

PART 50—REGULATIONS RELATING TO THE TAX IMPOSED WITH RESPECT TO CERTAIN HYDRAULIC MINING

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AUTHORITY: Sec. 23, 27, Stat. 510, as amended; 33 U.S.C. 683.

SOURCE: T.D. 6419, 24 FR 8546, Oct. 22, 1959, unless otherwise noted.

§ 50.1 Introduction.

The Act entitled ''An Act to create the California Debris Commission and regulate hydraulic mining in the State of California'', approved March 1, 1893, as amended, 27 Stat. 507; 34 Stat. 1001; 48 Stat. 1118; 52 Stat. 1040; 61 Stat. 501; 33 U.S.C. 661–687, provides in part as follows:

That a commission is hereby created, to be known as the California Debris Commission, consisting of three members. * * *

SEC. 3. That the jurisdiction of said commission, insofar as the same affects mining carried on by the hydraulic process, shall extend to all such mining in the territory drained by the Sacramento and San Joaquin river systems in the State of California. * * *

SEC. 8. That for the purposes of this act ''hydraulic mining'' and ''mining by the hydraulic process,'' are hereby declared to have the meaning and application given to said terms in said State.

SEC. 9. That the individual proprietor or proprietors, or in the case of a corporation its manager or agent appointed for that purpose, owning mining ground in the territory in the State of California mentioned in section three hereof, which it is desired to work by the hydraulic process, must file with said commission a verified petition, setting forth such facts as will comply with law and the rules prescribed by said commission.

* * * * *

SEC. 13. That in case a majority of the members of said Commission, within thirty days after the time so fixed, concur in the decision in favor of the petitioner or petitioners, the said Commission shall thereupon make an order directing the methods and specifying in detail the manner in which operations shall proceed in such mine or mines; * * *

SEC. 23. Upon the construction by the said commission of dams or other works for the detention of debris from hydraulic mines and the issuing of the order provided for by this Act to any individual, company, or corporation to work any mine or mines by hydraulic process, the individual, company, or corporation operating thereunder working any mine or mines by hydraulic process, the debris from which flows into or is in whole or in part restrained by such dams or other works erected by said commission, shall pay for each cubic yard mined from the natural bank a tax equal to the total capital cost of the dam, reservoir, and rights of way divided by the total capacity of the reservoir for the restraint of debris, as determined in each case by the California Debris Commission, which tax shall be paid annually on a date fixed by said commission and in accordance with regulations to be adopted by the Secretary of the Treasury, and the Treasurer of the United States is hereby authorized to receive the same. * * * The Secretary of the Army is authorized to enter into contracts to supply storage for water and use of outlet facilities from debris storage reservoirs, for domestic and irrigation purposes and power development upon such conditions of delivery, use, and payment as he may approve: *Provided,* That the moneys received from such contracts shall be deposited to the credit of the reservoir project from which the water is supplied, and the total capital cost of said reservoir, which is to be repaid by tax on mining operations as herein provided, shall be reduced in the amount so received.

§ 50.2 Scope of regulations.

(a) *In general.* The regulations in this part relate to the tax imposed with respect to hydraulic mining, the debris from which flows into or is in whole or in part restrained by dams or other works erected for the detention of debris by the California Debris Commission in the area drained by the Sacramento and San Joaquin river systems in the State of California. The regulations have application to taxable years beginning after August 31, 1959.

For definition of the term *taxable year*, see § 50.3(g).

(b) *Extent to which the regulations in this part supersede prior regulations*. The regulations in this part, with respect to the subject matter within the scope thereof, supersede Treasury Decision 4952 (26 CFR (1939) part 317).

§ 50.3 General definitions and use of terms.

As used in the regulations in this part:

(a) The term *Act* means ''An Act to create the California Debris Commission and regulate hydraulic mining in the State of California'' approved March 1, 1893, as amended, 27 Stat. 507; 34 Stat. 1001; 48 Stat. 1118; 52 Stat. 1040; 61 Stat. 501; 33 U.S.C. 661–687.

(b) The term *person* means an individual, a trust, estate, partnership, company, or corporation.

(c) The term *Secretary* means the Secretary of the Treasury.

(d) The term *Commissioner* means the Commissioner of Internal Revenue.

(e) The term *district director* means the district director of internal revenue.

(f) The terms *hydraulic mining* and *mining by the hydraulic process* shall have the meaning and application given said terms in the State of California.

(g) The term *taxable year* means the twelve-month period ending on August 31 of each year for which the tax imposed by the Act is payable.

§ 50.4 Rates of tax.

(a) *Determination of rate*. Under the Act the California Debris Commission will determine and prescribe with respect to each debris dam or other works the rate of tax payable in the area served by the particular debris dam or works. The Secretary of the Army will notify the Secretary of the Treasury of the rate of tax fixed with respect to each debris dam or works as such rate becomes known.

(b) *Measure of tax*. The tax is payable annually on the basis of the number of cubic yards mined from the natural bank by the hydraulic process during the taxable year.

§ 50.5 Liability for the tax.

Liability for tax attaches to any person engaged at any time during the taxable year in hydraulic mining in the area identified in paragraph (a) of § 50.2, if the debris from such mining operations is in whole or in part restrained by any of the debris dams or works constructed by the California Debris Commission.

§ 50.6 Ascertainment of quantity mined.

Each person engaged in hydraulic mining operations within the scope of the tax shall make or cause to be made appropriate surveys of the premises on which such hydraulic mining operations are conducted for the purpose of determining the cubic yardage mined from the natural bank. Such surveys shall be made at the beginning and end of hydraulic mining operations in each taxable year by a licensed engineer or other qualified agency having prior approval of the California Debris Commission, and shall conform to requirements prescribed by the California Debris Commission.

§ 50.7 Returns.

(a) *Form of return*. Every person liable for tax for any taxable year shall prepare for such year a return on Form 1 (California Debris) in accordance with the instructions thereon and in accordance with the regulations in this part.

(b) *Content of return*. The return shall show:

(1) The identity of the particular dam or other works restraining debris from the mine;

(2) The name and location of the mine;

(3) The name and address of the person to whom the California Debris Commission has issued a license to operate the mine;

(4) The number and date of the license;

(5) The name and address of the owner of the mine;

(6) The dates on which hydraulic mining operations began and ended during the taxable year for which the return is made;

(7) The number of cubic yards mined by the hydraulic process at the mine during the taxable year;

(8) The rate of tax per cubic yard determined by the California Debris Commission applicable to the particular mine; and

(9) The amount of tax due and payable (cubic yards mined multiplied by the rate of tax per cubic yard).

(c) *Supporting statement.* With each return there must be submitted a supporting statement of the person who made the surveys at the mine for the mining season covered by the return (see § 50.6), stating that such surveys were made in accordance with requirements prescribed by the California Debris Commission.

(d) *Verification of return and supporting statement.* The return and the supporting statement shall be verified by written declarations that they are made under the penalties of perjury.

§ 50.8 Due date and place for filing returns and paying tax.

The return for a taxable year shall be filed with, and the tax shall be paid to, the district director at San Francisco, California, on or before September 30 of the calendar year in which the taxable year ends. The tax is due and payable on such date without assessment by, or notice from, the district director.

PART 52—ENVIRONMENTAL TAXES

Sec.
52.0–1 Introduction.
52.4681–1 Taxes imposed with respect to ozone-depleting chemicals.
52.4682–1 Ozone-depleting chemicals.
52.4682–2 Qualifying sales.
52.4682–3 Imported taxable products.
52.4682–4 Floor stocks tax.
52.4682–5 Exports.

AUTHORITY: 26 U.S.C. 7805.

Section 52.4682–3 also issued under 26 U.S.C. 4682(c)(2);

Section 52.4682–5 also issued under 26 U.S.C. 4662(e)(4).

§ 52.0–1 Introduction.

The regulations in this part 52 are designated ''Environmental Tax Regulations.'' The regulations relate to the environmental taxes imposed by chapter 38 of the Internal Revenue Code. See part 40 of this chapter for regulations relating to returns, payments, and deposits of taxes imposed by chapter 38.

[T.D. 8442, 57 FR 48186, Oct. 22, 1992]

§ 52.4681–1 Taxes imposed with respect to ozone-depleting chemicals.

(a) *Taxes imposed.* Sections 4681 and 4682 impose the following taxes with respect to ozone-depleting chemicals (ODCs):

(1) *Tax on ODCs.* Section 4681(a)(1) imposes a tax on ODCs that are sold or used by the manufacturer or importer thereof. Except as otherwise provided in § 52.4682–1 (relating to the tax on ODCs), the amount of the tax is equal to the product of—

(i) The weight (in pounds) of the ODC;

(ii) The base tax amount (determined under section 4681(b)(1) (B) or (C)) for the calendar year in which the sale or use occurs; and

(iii) The ozone-depletion factor (determined under section 4682(b)) for the ODC.

(2) *Tax on imported taxable products.* Section 4681(a)(2) imposes a tax on imported taxable products that are sold or used by the importer thereof. Except as otherwise provided in § 52.4682–3 (relating to the tax on imported taxable products), the tax is computed by reference to the weight of the ODCs used as materials in the manufacture of the product. The amount of tax is equal to the tax that would have been imposed on the ODCs under section 4681(a)(1) if the ODCs had been sold in the United States on the date of the sale or use of the imported product. The weight of such ODCs is determined under § 52.4682–3.

(3) *Floor stocks tax*—(i) *Imposition of tax.* Section 4682(h) imposes a floor stocks tax on ODCs that—

(A) Are held by any person other than the manufacturer or importer of the ODC on a date specified in paragraph (a)(3)(ii) of this section; and

(B) Are held on such date for sale or for use in further manufacture.

(ii) Dates on which tax imposed. The floor stocks tax is imposed on January 1 of each calendar year after 1989.

(iii) *Amount of tax.* Except as otherwise provided in § 52.4682–4 (relating to the floor stocks tax), the amount of the

floor stocks tax is equal to the excess of—

(A) The tax that would be imposed on the ODC under section 4681(a)(1) if a sale or use of the ODC by its manufacturer or importer occurred on the date the floor stocks tax is imposed (the tentative tax amount), over

(B) The sum of the taxes previously imposed (if any) on the ODC under sections 4681 and 4682.

(b) *Cross-references*—(1) *Tax on ODCs*. Additional rules relating to the tax on ODCs are contained in §§ 52.4682–1 and 52.4682–2.

(2) *Tax on imported taxable products*. Additional rules relating to the tax on imported taxable products are contained in § 52.4682–3.

(3) *Floor stocks tax*. Additional rules relating to the floor stocks tax are contained in § 52.4682–4.

(4) *Returns, payments, and deposits of tax*. Rules requiring returns reporting the taxes imposed by sections 4681 and 4682 are contained in part 40 of this chapter. Part 40 of this chapter also provides rules relating to the use of Government depositaries and to the time for filing returns and making payments of tax.

(c) *Definitions of general application*. The following definitions set forth the meaning of certain terms for purposes of the regulations under sections 4681 and 4682:

(1) *Ozone-depleting chemical*. The term ''ozone-depleting chemical'' (ODC) means any chemical listed in section 4682(a)(2).

(2) *United States*. The term ''United States'' has the meaning given such term by section 4612(a)(4). Under section 4612(a)(4)—

(i) The term ''United States'' means the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, any possession of the United States, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands; and

(ii) The term includes—

(A) Submarine seabed and subsoil that would be treated as part of the United States (as defined in paragraph (c)(2)(i) of this section) under the principles of section 638 relating to continental shelf areas; and

(B) Foreign trade zones of the United States.

(3) *Manufacture; manufacturer*. The term ''manufacture'' when used with respect to any ODC or imported product includes its production, and the term ''manufacturer'' includes a producer.

(4) *Entry into United States for consumption, use, or warehousing*—(i) *In general*. Except as otherwise provided in this paragraph (c)(4), the term ''entered into the United States for consumption, use, or warehousing'' when used with respect to any goods means—

(A) Brought into the customs territory of the United States (the customs territory) if applicable customs law requires that the goods be entered into the customs territory for consumption, use, or warehousing;

(B) Admitted into a foreign trade zone for any purpose if like goods brought into the customs territory for such purpose would be entered into the customs territory for consumption, use, or warehousing; or

(C) Imported into any other part of the United States (as defined in paragraph (c)(2) of this section) for any purpose if like goods brought into the customs territory for such purpose would be entered into the customs territory for consumption, use, or warehousing.

(ii) *Entry for transportation and exportation*. Goods entered into the customs territory for transportation and exportation are not goods entered for consumption, use, or warehousing.

(iii) *Entries described in two or more provisions*. In the case of any goods with respect to which entries are described in two or more provisions of paragraph (c)(4)(i) of this section, only the first such entry is taken into account. Thus, if the admission of goods into a foreign trade zone is an entry into the United States for consumption, use, or warehousing, the subsequent entry of such goods into the customs territory will not be treated as an entry into the United States for consumption, use, or warehousing.

(iv) *Certain imported products not entered for consumption, use, or warehousing*. Imported products that are entered into the United States for consumption, use, or warehousing do

not include any imported products that—

(A) Are entered into the customs territory under Harmonized Tariff Schedule (HTS) heading 9801, 9802, 9803, or 9813;

(B) Would, if entered into the customs territory, be entered under any such heading; or

(C) Are brought into the United States by an individual if the product is brought in for use by the individual and is not expected to be used in a trade or business other than a trade or business of performing services as an employee.

(5) *Importer*. The term ''importer'' means the person that first sells or uses goods after their entry into the United States for consumption, use, or warehousing (within the meaning of paragraph (c)(4) of this section).

(6) *Sale*. The term ''sale'' means the transfer of title or of substantial incidents of ownership (whether or not delivery to, or payment by, the buyer has been made) for consideration which may include money, services, or property. The determination as to the time a sale occurs shall be made under applicable local law.

(7) *Use*—(i) *In general*. Except as otherwise provided in regulations under sections 4681 and 4682, ODCs and imported taxable products are used when they are—

(A) Used as a material in the manufacture of an article, whether by incorporation into such article, chemical transformation, release into the atmosphere, or otherwise; or

(B) Put into service in a trade or business or for production of income.

(ii) *Loss, destruction, packaging, warehousing, and repair*. The loss, destruction, packaging (including repackaging), warehousing, or repair of ODCs and imported taxable products is not a use of the ODC or product lost, destroyed, packaged, warehoused, or repaired.

(iii) *Cross-references to exceptions*. For exceptions to the rule contained in paragraph (c)(7)(i) of this section, see—

(A) Section 52.4682–1(b)(2)(iii) (relating to mixture elections), § 52.4682–1(b)(2)(iv) (relating to mixtures for export), and § 52.4682–1(b)(2)(v) (relating to mixtures for use as a feedstock);

(B) Section 52.4682–3(c)(2) (relating to the election to treat entry of an imported taxable product as use); and

(C) Section 52.4682–3(c)(3) (relating to treating sale of an article incorporating an imported taxable product as the first sale or use of the product).

(8) *Pound*. The term ''pound'' means a unit of weight that is equal to 16 avoirdupois ounces.

(9) *Post-1990 ODC; post-1989 ODC*. The term ''post-1990 ODC'' means any ODC that is listed below Halon–2402 in the table contained in section 4682(a)(2). The term ''post-1989 ODC'' means any ODC other than a post-1990 ODC.

(d) *Effective date*. Sections 52.4681–0, 52.4681–1, 52.4682–1, 52.4682–2, 52.4682–3, and 52.4682–4 are effective as of January 1, 1990, and apply to—

(1) Post-1989 ODCs that the manufacturer or importer thereof first sells or uses after December 31, 1989, and post-1990 ODCs that the manufacturer or importer thereof first sells or uses after December 31, 1990;

(2) Imported taxable products that the importer thereof first sells or uses after December 31, 1989 (but, in the case of products first sold or used before January 1, 1991, by taking into account only the post-1989 ODCs used as materials in their manufacture); and

(3) Post-1989 ODCs held for sale or for use in further manufacture by any person other than the manufacturer or importer thereof on January 1, 1990, and post-1989 and post-1990 ODCs that are so held on January 1 of each calendar year after 1990.

[T.D. 8370, 56 FR 56305, Nov. 4, 1991, as amended by T.D. 8442, 57 FR 48186, Oct. 22, 1992; T.D. 8622, 60 FR 52849, Oct. 11, 1995]

§ 52.4682–1 Ozone-depleting chemicals.

(a) *Overview*. This section provides rules relating to the tax imposed on ozone-depleting chemicals (ODCs) under section 4681, including rules for identifying taxable ODCs and determining when the tax is imposed, and rules prescribing special treatment for certain ODCs. See § 52.4681–1(a)(1) and (c) for general rules and definitions relating to the tax on ODCs.

(b) *Taxable ODCs; taxable event*—(1) *Taxable ODCs*—(i) *In general*. Except as provided in paragraphs (c) through (g) of this section, an ODC is taxable if—

(A) It is listed in section 4682(a)(2) on the date it is sold or used by its manufacturer or importer; and

(B) It is manufactured in the United States or entered into the United States for consumption, use, or warehousing.

(ii) *Storage containers.* An ODC described in paragraph (b)(1)(i) of this section is taxable without regard to the type or size of storage container in which the ODC is held.

(iii) *Example.* The application of this paragraph (b)(1) may be illustrated by the following example:

Example. A brings CFC–12, an ODC listed in section 4682(a)(2), into the customs territory and enters the CFC–12 for transportation and exportation. The ODC is not taxable because it is not entered for consumption, use, or warehousing. The ODC also would not be taxable if it were admitted to a foreign trade zone (rather than brought into the customs territory) for transportation and exportation.

(2) *Taxable event*—(i) *In general*—(A) *General rule.* The tax on an ODC is imposed when the ODC is first sold or used (as defined in § 52.4681–1(c)(6) and (7)) by its manufacturer or importer.

(B) *Example.* The application of this paragraph (b)(2)(i) may be illustrated by the following example:

Example. A enters CFC–113, an ODC listed in section 4682(a)(2), into the United States for consumption, use, or warehousing. A warehouses the CFC–113 and then decides to ship the ODC to its factory outside the United States (as defined in § 52.4681–1 (c)(2)). The CFC–113 is a taxable ODC because the requirements of paragraph (b)(1)(i) of this section have been met. However, tax is not imposed on the ODC because there is no taxable event. A did not sell the ODC and, under § 52.4681–1(c)(7), warehousing is not a use.

(ii) *Mixtures.* Except as provided in paragraphs (b)(2)(iii), (iv), and (v) of this section, the creation of a mixture containing two or more ingredients is treated as a taxable use of the ODCs contained in the mixture. For this purpose, a mixture cannot be represented by a chemical formula, and an ODC is contained in a mixture only if the chemical identity of the ODC is not changed. Thus, except as provided in paragraphs (b)(2)(iii), (iv), and (v) of this section—

(A) The tax on the post-1989 ODCs (as defined in § 52.4681–1(c)(9)) contained in mixtures created after December 31, 1989, or on the post-1990 ODCs (as defined in § 52.4681–1(c)(9)) contained in mixtures created after December 31, 1990, is imposed when the mixture is created and not on any subsequent sale or use of the mixture; and

(B) No tax is imposed under section 4681 on the post-1989 ODCs contained in mixtures created before January 1, 1990, or on the post-1990 ODCs contained in mixtures created before January 1, 1991.

(iii) *Mixture elections*—(A) *Permitted elections.* The only elections permitted under this paragraph (b)(2)(iii) are—

(*1*) An election for the first calendar quarter beginning after December 31, 1989, and all subsequent periods (the 1990 election); and

(*2*) An election for the first calendar quarter beginning after December 31, 1990, and all subsequent periods (the 1991 election).

(B) *In general.* A manufacturer or importer may elect to treat the sale or use of mixtures containing ODCs as the first sale or use of the ODCs contained in the mixtures. If a 1990 election is made under this paragraph (b)(2)(iii), the tax on post-1989 ODCs contained in a mixture sold or used after December 31, 1989 (including any such mixture created before January 1, 1990) is imposed on the date of such sale or use. Similarly, if a 1991 election is made under this paragraph (b)(2)(iii), the tax on post-1990 ODCs contained in a mixture sold or used after December 31, 1990 (including any such mixture created before January 1, 1991) is imposed on the date of such sale or use.

(C) *Applicability of elections.* An election under this paragraph (b)(2)(iii) applies—

(*1*) In the case of a 1990 election, to all post-1989 ODCs contained in mixtures sold or used by the manufacturer or importer after December 31, 1989 (including any such mixture created before January 1, 1990); and

(*2*) In the case of a 1991 election, to all post-1990 ODCs contained in mixtures sold or used by the manufacturer or importer after December 31, 1990 (including any such mixture created before January 1, 1991).

(D) *Making the election; revocation.* An election under this paragraph (b)(2)(iii)

shall be made in accordance with the instructions for the return on which the manufacturer or importer reports liability for tax under section 4681. After October 9, 1990, the election may be revoked only with the consent of the Commissioner.

(iv) *Special rule for exports.* The creation of a mixture for export is not a taxable use of the ODCs contained in the mixture. If a manufacturer or importer sells a mixture for export, § 52.4682–5 applies to the ODCs contained in the mixture. See § 52.4682–5(e) for rules relating to liability of a purchaser for tax if the mixture is not exported.

(v) *Special rule for use as a feedstock.* The creation of a mixture for use as a feedstock (within the meaning of paragraph (c) of this section) is not a taxable use of the ODCs contained in the mixture.

(c) *ODCs used as a feedstock*—(1) *Exemption from tax.* No tax is imposed on an ODC if the manufacturer or importer of the ODC—

(i) Uses the ODC as a feedstock in the manufacture of another chemical; or

(ii) Sells the ODC in a qualifying sale (within the meaning of paragraph (c)(4) of this section) for use as a feedstock.

(2) *Excess payments*—(i) *In general.* Under section 4682(d)(2)(B), a credit or refund is allowed to a person if—

(A) The person uses an ODC as a feedstock; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 was not determined under section 4682(d)(2)(A).

(ii) *Procedural rules.* See section 6402 and the regulations thereunder for rules relating to claiming a credit or refund of tax paid with respect to ODCs that are used as a feedstock. A credit against the income tax is not allowed for the amount determined under section 4682(d)(2)(B).

(3) *Definition.* An ODC is used as a feedstock only if the ODC is entirely consumed (except for trace amounts) in the manufacture of another chemical. Thus, the transformation of an ODC into one or more new compounds (such as the transformation of CFC–113 into chlorotrifluoroethylene (CTFE or 1113), of CFC–113 into CFC–115 and CFC–116, or of carbon tetrachloride into hydrochloric acid during petroleum refining or incineration) is treated as use as a feedstock. On the other hand, the ODCs used in a mixture (including an azeotrope such as R–500 or R–502) are not used as a feedstock.

(4) *Qualifying sale.* A sale of ODCs for use as a feedstock is a qualifying sale if the requirements of § 52.4682–2(b)(1) are satisfied with respect to such sale.

(d) *ODCs used in the manufacture of rigid foam insulation*—(1) *Phase-in of tax*—(i) *In general.* The amount of tax imposed on an ODC is determined under section 4682(g) if the manufacturer or importer of the ODC—

(A) Uses the ODC during 1990, 1991, 1992, or 1993 in the manufacture of rigid foam insulation; or

(B) Sells the ODC in a qualifying sale (within the meaning of paragraph (d)(5) of this section) during 1990, 1991, 1992, or 1993.

(ii) *Amount of tax.* Under section 4682(g), ODCs described in paragraph (d)(1)(i) of this section are not taxed if sold or used during 1990 and are taxed at a reduced rate if sold or used during 1991, 1992, or 1993.

(2) *Excess payments*—(i) *In general.* Under section 4682(g)(3), a credit against income tax or a refund is allowed to a person if—

(A) The person uses an ODC during 1990, 1991, 1992, or 1993 in the manufacture of rigid foam insulation; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 was not determined under section 4682(g).

(ii) *Procedural rules*—(A) The amount determined under section 4682(g)(3) shall be treated as a credit described in section 34(a) (relating to credits for gasoline and special fuels) unless a claim for refund has been filed.

(B) See section 6402 and the regulations thereunder for rules relating to claiming a credit or refund of the tax paid with respect to ODCs that are used in the manufacture of rigid foam insulation.

(3) *Definition*—(i) *Rigid foam insulation.* The term ''rigid foam insulation'' means any rigid foam that is designed for use as thermal insulation in buildings, equipment, appliances, tanks, railcars, trucks, or vessels, or on pipes, including any such rigid foam actually

used for purposes other than insulation. Information such as test reports on R-values and advertising material reflecting R-value claims for a particular rigid foam may be used to show that such rigid foam is designed for use as thermal insulation.

(ii) *Rigid foam*—(A) *In general.* The term ''rigid foam'' means any closed cell polymeric foam (whether or not rigid) in which chlorofluorocarbons are used to fill voids within the polymer.

(B) *Examples of rigid foam products.* Rigid foam includes extruded polystyrene foam, polyisocyanurate foam, spray and pour-in-place polyurethane foam, polyethylene foam, phenolic foam, and any other product that the Commissioner identifies as rigid foam in a pronouncement of general applicability. The form of a product identified under this paragraph (d)(3)(ii)(B) does not affect its character as rigid foam. Thus, such products are rigid foam whether in the form of a board, sheet, backer rod, or wrapping, or in a form applied by spraying, pouring, or frothing.

(4) *Use in manufacture.* An ODC is used in the manufacture of rigid foam insulation if it is incorporated into such product or is expended as a propellant or otherwise in the manufacture or application of such product.

(5) *Qualifying sale.* A sale of an ODC for use in the manufacture of rigid foam insulation is a qualifying sale if the requirements of § 52.4682–2(b)(2) are satisfied with respect to such sale.

(e) *Halons; phase-in of tax.* The amount of tax imposed on Halon-1211, Halon-1301, or Halon-2402 (Halons) is determined under section 4682(g) if the manufacturer or importer of Halons sells or uses Halons during 1990, 1991, 1992, or 1993. Under section 4682(g), Halons are not taxed if sold or used during 1990 and are taxed at a reduced rate if sold or used during 1991, 1992, or 1993.

(f) *Methyl chloroform; reduced rate of tax in 1993.* The amount of tax imposed on methyl chloroform is determined under section 4682(g)(5) if the manufacturer or importer of the methyl chloroform sells or uses it during 1993.

(g) *ODCs used as medical sterilants*—(1) *Phase-in of tax.* The amount of tax imposed on an ODC is determined under section 4682(g)(4) if the manufacturer or importer of the ODC—

(i) Uses the ODC during 1993 as a medical sterilant; or

(ii) Sells the ODC in a qualifying sale (within the meaning of paragraph (g)(4) of this section) during 1993.

(2) *Excess payments*—(i) *In general.* Under section 4682(g)(4)(B), a credit against income tax (without interest) or a refund of tax (without interest) is allowed to a person if—

(A) The person uses an ODC during 1993 as a medical sterilant; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 exceeds the amount that would have been determined under section 4682(g)(4).

(ii) *Amount of credit or refund.* The amount of credit or refund of tax is equal to the excess of—

(A) The tax that was paid with respect to the ODCs under sections 4681 and 4682; over

(B) The tax that would have been imposed under section 4682(g)(4).

(iii) *Procedural rules.* (A) The amount determined under section 4682(g)(4)(B) and paragraph (g)(2)(ii) of this section is treated as a credit described in section 34(a) (relating to credits for gasoline and special fuels) unless a claim for refund has been filed.

(B) See section 6402 and the regulations under that section for procedural rules relating to claiming a credit or refund of tax.

(3) *Definition of use as a medical sterilant.* An ODC is used as a medical sterilant if it is used in the manufacture of sterilant gas.

(4) *Qualifying sale.* A sale of an ODC for use as a medical sterilant is a qualifying sale if the requirements of § 52.4682–2(b)(3) are satisfied with respect to the sale.

(h) *ODCs used as propellants in metered-dose inhalers*—(1) *Reduced rate of tax.* The amount of tax imposed on an ODC is determined under section 4682(g)(4) if the manufacturer or importer of the ODC—

(i) Uses the ODC after 1992 as a propellant in a metered-dose inhaler; or

(ii) Sells the ODC in a qualifying sale (within the meaning of paragraph (h)(4) of this section) after 1992.

(2) *Excess payments*—(i) *In general*. Under section 4682(g)(4)(B), a credit against income tax (without interest) or a refund of tax (without interest) is allowed to a person if—

(A) The person uses an ODC after 1992 as a propellant in a metered-dose inhaler; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 exceeds the amount that would have been determined under section 4682(g)(4).

(ii) *Amount of credit or refund*. The amount of credit or refund of tax is equal to the excess of—

(A) The tax that was paid with respect to the ODCs under sections 4681 and 4682; over

(B) The tax that would have been imposed under section 4682(g)(4).

(iii) *Procedural rules*—(A) The amount determined under section 4682(g)(4)(B) and paragraph (h)(2)(ii) of this section is treated as a credit described in section 34(a) (relating to credits for gasoline and special fuels) unless a claim for refund has been filed.

(B) See section 6402 and the regulations under that section for procedural rules relating to claiming a credit or refund of tax.

(3) *Definition of metered-dose inhaler*. A metered-dose inhaler is an aerosol device that delivers a precisely-measured dose of a therapeutic drug.

(4) *Qualifying sale*. A sale of an ODC for use as a propellant for a metered-dose inhaler is a qualifying sale if the requirements of § 52.4682–2(b)(4) are satisfied with respect to the sale.

(i) [Reserved]

(j) *Exports; cross-reference*. For the treatment of exports of ODCs, see § 52.4682–5.

(k) *Recycling*. [Reserved]

[T.D. 8370, 56 FR 56307, Nov. 4, 1991, as amended by T.D. 8622, 60 FR 52849, Oct. 11, 1995]

§ 52.4682–2 Qualifying sales.

(a) *In general*—(1) *Special rules applicable to certain sales*. Special rules apply to sales of ODCs in the following cases:

(i) Under section 4682(d)(2), § 52.4682–1(c), and § 52.4682–4(b)(2)(v) (relating to ODCs used as a feedstock), ODCs sold in qualifying sales are not taxed.

(ii) Under section 4682(g), § 52.4682–1(d), and § 52.4682–4(d)(2) (relating to ODCs used in the manufacture of rigid foam insulation), ODCs sold in qualifying sales are not taxed in 1990 and are taxed at a reduced rate in 1991, 1992, and 1993.

(iii) Under section 4682(g)(4) and § 52.4682–1(g) (relating to ODCs used as medical sterilants), ODCs sold in qualifying sales are taxed at a reduced rate in 1993.

(iv) Under section 4682(g)(4) and § 52.4682–1(h) (relating to ODCs used as propellants in metered-dose inhalers), ODCs sold in qualifying sales are taxed at a reduced rate in years after 1992.

(2) *Qualifying sales*. A sale of ODCs is not a qualifying sale unless the requirements of this section are satisfied. Although registration with the Internal Revenue Service is not required to establish that a sale of ODCs is a qualifying sale, the certificates required by this section shall be made available for inspection by internal revenue agents and officers.

(b) *Requirements for qualification*—(1) *Use as a feedstock*. A sale of ODCs is a qualifying sale for purposes of §§ 52.4682–1(c) and 52.4682–4(b)(2)(v) if the manufacturer or importer of the ODCs—

(i) Obtains a certificate in substantially the form set forth in paragraph (d)(2) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(2) *Use in the manufacture of rigid foam insulation*. A sale of ODCs is a qualifying sale for purposes of §§ 52.4682–1(d) and 52.4682–4(d)(2) if the manufacturer or importer of the ODCs—

(i) Obtains a certificate in substantially the form set forth in paragraph (d)(3) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(3) *Use as medical sterilants*. A sale of ODCs is a qualifying sale for purposes of § 52.4682–1(g) if the manufacturer or importer of the ODCs—

(i) Obtains a certificate in substantially the form set forth in paragraph (d)(4) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(4) *Use as propellants in metered-dose inhalers.* A sale of ODCs is a qualifying sale for purposes of §§ 52.4682–1(h) and 52.4682–4(b)(2)(vii) if the manufacturer or importer of the ODCs—

(i) Obtains a certificate in substantially the form set forth in paragraph (d)(5) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(c) *Good faith reliance*—(1) *In general.* The requirements of paragraph (b) of this section are not satisfied with respect to a sale of ODCs and the sale is not a qualifying sale if at the time of the sale—

(i) The manufacturer or importer has reason to believe that the purchaser will use the ODCs other than for the purpose set forth in the certificate; or

(ii) The Internal Revenue Service has notified the manufacturer or importer that the purchaser's right to provide a certificate has been withdrawn.

(2) *Withdrawal of right to provide a certificate.* The Internal Revenue Service may withdraw the right of a purchaser to provide a certificate to its supplier if such purchaser uses the ODCs to which its certificate applies other than for the purpose set forth in such certificate, or otherwise fails to comply with the terms of the certificate. The Internal Revenue Service may notify the supplier to whom the purchaser provided the certificate that the purchaser's right to provide a certificate has been withdrawn.

(d) *Certificate*—(1) *In general*—(i) *Rules relating to all certificates.* This paragraph (d) sets forth certificates that satisfy the requirements of paragraphs (b)(1) through (4) of this section. The certificate shall consist of a statement executed and signed under penalties of perjury by a person with authority to bind the purchaser. A certificate provided under paragraph (d)(2) or (5) of this section may apply to a single purchase or to multiple purchases and need not specify an expiration date. A certificate provided under paragraph (d)(3) or (4) of this section may apply to a single purchase or multiple purchases, and will expire as of December 31, 1993, unless an earlier expiration date is specified in the certificate. A new certificate must be given to the supplier if any information on the current certificate changes. The certificate may be included as part of any business records normally used to document a sale.

(ii) *Special rule relating to certificates executed before January 1, 1992.* Certificates provided under this paragraph (d)(2) and executed before January 1, 1992, satisfy the requirements of paragraph (b) of this section if they are in substantially the same form as certificates set forth in § 52.4682–2T.

(2) *Certificate relating to ODCs used as a feedstock*—(i) *ODCs that will be resold for use by the second purchaser as a feedstock.* If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser as a feedstock, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD FOR USE BY THE SECOND PURCHASER AS A FEEDSTOCK

(To support tax-free sales under section 4682(d)(2) of the Internal Revenue Code.)

Date _____

The undersigned purchaser (''Purchaser'') hereby certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from

_____

(name and address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use as a feedstock (as defined in § 52.4682–1(c)(3) of the Environmental Tax Regulations).

Product	Percentage
CFC–11.	
CFC–12.	
CFC–113.	
CFC–114.	
CFC–115.	
Carbon tetrachloride.	
Methyl chloroform.	
Other (specify).	

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(d)(2)(B) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Signature

_____

Printed or typed name of person signing

_____

Title of person signing

_____

Name of Purchaser

_____

Address

_____

_____

Taxpayer Identifying Number

(ii) *ODCs that will be used by the purchaser as a feedstock.* If the purchaser will use the ODCs as a feedstock, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY THE PURCHASER AS A FEEDSTOCK

(To support tax-free sales under section 4682(d)(2) of the Internal Revenue Code.)

Date _____

The undersigned purchaser (''Purchaser'') hereby certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from

_____

(name and address of seller)

will be used by Purchaser as a feedstock (as defined in § 52.4682–1(c)(3) of the Environmental Tax Regulations).

Product	Percentage	Kilograms to be transformed
CFC–11.		
CFC–12.		
CFC–113.		
CFC–114.		
CFC–115.		
Carbon tetrachloride.		
Methyl chloroform.		
Other (specify).		

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(d)(2)(B) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use of the ozone-depleting chemicals to which this certificate applies other than as a feedstock may result in the withdrawal by the Internal

Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use as a feedstock of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____
Signature

_____
Printed or typed name of person signing

_____
Title of person signing

_____
Name of Purchaser

_____
Address

_____
_____
Taxpayer Identifying Number

(3) *Certificate relating to ODCs used in the manufacture of rigid foam insulation*—(i) *ODCs that will be resold to a second purchaser for use by the second purchaser in the manufacture of rigid foam insulation*. If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser in the manufacture of rigid foam insulation, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD FOR USE BY THE SECOND PURCHASER IN THE MANUFACTURE OF RIGID FOAM INSULATION

(To support tax-free or tax-reduced sales under section 4682(g) of the Internal Revenue Code.)

Effective Date _____
Expiration Date _____
(not after 12/31/93)

The undersigned purchaser (''Purchaser'') hereby certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from

_____
(name and address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use in the manufacture of rigid foam insulation (as defined in § 52.4682–1(d)(3) and (4) of the Environmental Tax Regulations).

Product	Percentage
CFC–11.	
CFC–12.	
CFC–113.	
CFC–114.	
CFC–115.	
Carbon tetrachloride.	
Methyl chloroform.	
Other (specify).	

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____
_____
_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____
_____
_____

_____ All shipments to Purchaser under the following purchase order(s):

_____
_____
_____

_____ One or more shipments to Purchaser identified as follows:

_____
_____
_____

Purchaser will not claim a credit or refund under section 4682(g)(3) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-

depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Signature

Printed or typed name of person signing

Title of person signing

Name of Purchaser

Address

Taxpayer Identifying Number

(ii) *ODCs that will be used by the purchaser in the manufacture of rigid foam insulation*. If the purchaser will use the ODCs in the manufacture of rigid foam insulation, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY THE PURCHASER IN THE MANUFACTURE OF RIGID FOAM INSULATION

(To support tax-free or tax-reduced sales under section 4682(g) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____
(not after 12/31/93)

The undersigned purchaser (''Purchaser'') hereby certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from

(name and address of seller)

will be used by Purchaser in the manufacture of rigid foam insulation (as defined in § 52.4682–1(d) (3) and (4) of the Environmental Tax Regulations).

Product	Percentage
CFC–11.	
CFC–12.	
CFC–113.	
CFC–114.	
CFC–115.	
Carbon tetrachloride.	
Methyl chloroform.	
Other (specify).	

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser will not claim a credit or refund under section 4682(g)(3) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than in the manufacture of rigid foam insulation may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use in the manufacture of rigid foam insulation of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Signature

Printed or typed name of person signing

Title of person signing

Name of Purchaser

Address

Taxpayer Identifying Number

(4) *Certificate relating to ODCs used as medical sterilants*—(i) *ODCs that will be*

resold for use by the second purchaser as medical sterilants. If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser as medical sterilants, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD FOR USE BY THE SECOND PURCHASER AS MEDICAL STERILANTS

(To support tax-reduced sales under section 4682(g)(4) of the Internal Revenue Code.)

Effective Date _____
Expiration Date _____
(not after 12/31/93)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from:

_____
(Name of seller)

_____
(Address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use as medical sterilants (as defined in § 52.4682–1(g)(3) of the Environmental Tax Regulations).

Product	Percentage
CFC–12	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____
_____
_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____
_____
_____

_____ All shipments to Purchaser under the following purchase order(s):

_____
_____
_____

_____ One or more shipments to Purchaser identified as follows:

_____
_____
_____

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____
Name of Purchaser

_____
Address of Purchaser

_____
_____
Taxpayer Identifying Number of Purchaser

_____
Title of person signing

_____
Printed or typed name of person signing

_____
Signature

(ii) *ODCs that will be used by the purchaser as medical sterilants*. If the purchaser will use the ODCs as medical sterilants, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY THE PURCHASER AS MEDICAL STERILANTS

(To support tax-reduced sales under section 4682(g)(4) of the Internal Revenue Code.)

Effective Date _____
Expiration Date _____
(not after 12/31/93)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from:

_____
(Name of seller)

_____
(Address of seller)

will be used by Purchaser as medical sterilants (as defined in § 52.4682–1(g)(3) of the Environmental Tax Regulations).

Product	Percentage
CFC–12	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than as medical sterilants may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use as medical sterilants of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

(5) *Certificate relating to ODCs used as propellants in metered-dose inhalers*—(i) *ODCs that will be resold for use by the second purchaser as propellants in metered-dose inhalers.* If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser as propellants in metered-dose inhalers, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD FOR USE BY THE SECOND PURCHASER AS PROPELLANTS IN METERED-DOSE INHALERS

(To support tax-reduced sales under section 4682(g)(4) of the Internal Revenue Code.)

Date _____

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use as propellants in metered-dose inhalers (as defined in § 52.4682–1(h)(3) of the Environmental Tax Regulations).

Product	Percentage
CFC–11	_____
CFC–12	_____
CFC–114	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

_____

_____

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Name of Purchaser

_____

Address of Purchaser

_____

_____

Taxpayer Identifying Number of Purchaser

_____

Title of person signing

_____

Printed or typed name of person signing

_____

Signature

(ii) *ODCs that will be used by the purchaser as propellants in metered-dose inhalers.* If the purchaser will use the ODCs as propellants in metered-dose inhalers, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY THE PURCHASER AS PROPELLANTS IN METERED-DOSE INHALERS

(To support tax-reduced sales under section 4682(g)(4) of the Internal Revenue Code.)

Date _____

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from:

_____

(Name of seller)

_____

(Address of seller)

will be used by Purchaser as propellants in metered-dose inhalers (as defined in § 52.4682–1(h)(3) of the Environmental Tax Regulations).

Product	Percentage
CFC–11	_____
CFC–12	_____
CFC–114	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than as propellants in metered-dose inhalers may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use as propellants in metered-dose inhalers of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment,

or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

[T.D. 8370, 56 FR 56308, Nov. 4, 1991, as amended by T.D. 8622, 60 FR 52850, Oct. 11, 1995]

§ 52.4682–3 Imported taxable products.

(a) *Overview; references to Tables; special rule for 1990*—(1) *Overview*. This section provides rules relating to the tax imposed on imported taxable products under section 4681, including rules for identifying imported taxable products, determining the weight of the ozone-depleting chemicals (ODCs) used as materials in the manufacture of such products, and computing the amount of tax on such products. See § 52.4681–1(a)(2) and (c) for general rules and definitions relating to the tax on imported taxable products.

(2) *References to Tables*. When used in this section—

(i) The term *Imported Products Table* (Table) refers to the Table set forth in paragraph (f)(6) of this section; and

(ii) The term *current Imported Products Table* (current Table) used with respect to a product refers to the Table in effect on the date such product is first sold or used by the importer thereof.

(3) *Special rule for 1990*. In the case of products first sold or used before January 1, 1991, post-1990 ODCs (as defined in § 52.4681–1(c)(9)) shall not be taken into account in applying the rules of this section.

(b) *Imported taxable products*—(1) *In general*—(i) *Rule*. Except as provided in paragraph (b)(2) of this section, the term ''imported taxable product'' means any product that—

(A) Is entered into the United States for consumption, use, or warehousing; and

(B) Is listed in the current Table.

(ii) *Example*. The application of this paragraph (b)(1) may be illustrated by the following example:

Example. A brings a light truck with a Harmonized Tariff Schedule classification of 8704 into the customs territory and enters the truck for transportation and exportation. Although the truck is listed in the current Table, it is not an imported taxable product because it is not entered for consumption, use, or warehousing. The truck also would not be an imported taxable product if it were admitted to a foreign trade zone (rather than brought into the customs territory) for transportation and exportation.

(2) *Exceptions*—(i) *In general*. A product is not treated as an imported taxable product if—

(A) The product is listed in Part I of the current Table and the adjusted tax with respect to the product is *de minimis* (within the meaning of paragraph (b)(2)(ii) of this section); or

(B) The product is listed in Part II of the current Table, the adjusted tax with respect to the product is *de minimis* (within the meaning of paragraph (b)(2)(ii) of this section), and the ODCs (other than methyl chloroform) used as materials in the manufacture of the product were not used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

(ii) *De minimis adjusted tax*. The adjusted tax with respect to a product is *de minimis* if such tax is less than one/tenth of one percent of the importer's cost of acquiring such product. The term *adjusted tax* means the tax that would be imposed under section 4681 on the ODCs used as materials in the manufacture of such product if such ODCs were sold in the United States and the base tax amount were $1.00.

(c) *Taxable event*—(1) *In general*. Except as otherwise provided in paragraphs (c) (2) and (3) of this section, the tax on an imported taxable product is imposed when the product is first sold or used (as defined in § 52.4681–1(c) (6) and (7)) by its importer. Thus, for example, imported taxable products that are warehoused or repackaged after entry and then exported without being sold or used in the United States are not subject to tax.

(2) *Election to treat importation as use*—(i) *In general*. An importer may elect to treat the entry of products

into the United States as the use of such products. In the case of imported taxable products to which an election under this paragraph (c)(2) applies—

(A) Tax is imposed on the products on the date of entry (as determined under paragraph (c)(2)(ii) of this section) if the products are entered into the United States after the election becomes effective;

(B) Tax is imposed on the products on the date the election becomes effective if the products were entered into the United States after December 31, 1989, and before the election becomes effective; and

(C) No tax is imposed if the products were entered into the United States before January 1, 1990.

(ii) *Date of entry*. The date of entry is determined by reference to customs law. If the actual date is unknown, the importer may use any reasonable and consistent method to determine the date of entry, provided that such date is within 10 business days of arrival of products in the United States.

(iii) *Applicability of election*. An election under this paragraph (c)(2) applies to all imported taxable products that are owned (and have not been used) by the importer at the time the election becomes effective and all imported taxable products that are entered into the United States by the importer after the election becomes effective. An election under this paragraph (c)(2) becomes effective at the beginning of the first calendar quarter to which the election applies. After October 9, 1990, the election may be revoked only with the consent of the Commissioner.

(iv) *Making the election*. An election under this paragraph (c)(2) shall be made in accordance with the instructions for the return on which the importer is required to report liability for tax under section 4681.

(3) *Treating the sale of an article incorporating an imported taxable product as the first sale or use of such product*—(i) *In general*. In the case of articles to be sold, an importer may treat the sale of an article manufactured or assembled in the United States as the first sale or use of an imported taxable product incorporated in such article, but only if the importer—

(A) Has consistently treated the sale of similar articles as the first sale or use of similar imported taxable products; and

(B) Has not made an election under paragraph (c)(2) of this section.

(ii) *Similar articles and imported taxable products*. An importer may establish any reasonable criteria for determining whether articles or imported taxable products are similar for purposes of this paragraph (c)(3).

(iii) *Establishment of consistent treatment*. An importer has consistently treated the sale of similar articles as the first sale or use of similar imported taxable products only if such treatment is reflected in the computation of tax on the importer's returns for all prior calendar quarters in which such treatment would affect tax liability.

(iv) *Example*. The application of this paragraph (c)(3) may be illustrated by the following example:

Example. (a) An importer of printed circuits and other electronic components uses those products in assembling television receivers in the United States and also uses the printed circuits in assembling VCRs in the United States. Under the importer's criteria for determining similarity, printed circuits are similar to other printed circuits, but not to the other electronic components. In addition, television receivers are similar to other television receivers, but not to VCRs. The importer has not made an election under paragraph (c)(2) of this section.

(b) Under this paragraph (c)(3), the importer may treat the sale of the television receivers as the first sale or use of the imported printed circuits incorporated into the television receivers. In that case, the tax on the printed circuits would be imposed when the television receivers are sold rather than when the printed circuits are used in assembling the television receivers.

(c) The importer may treat the sale of the television receivers as the first sale or use of the printed circuits incorporated into the television receivers even if the sale of the television receivers is not treated as the first sale or use of the other electronic components incorporated into the television receivers and even if the sale of VCRs is not treated as the first sale or use of the printed circuits incorporated into the VCRs. Under paragraph (c)(3)(i)(A) of this section, however, the importer must have consistently treated the sale of television receivers as the first sale or use of printed circuits incorporated into the receivers. Thus, in the case of television receivers that were assembled

before January 1, 1990, and sold after December 31, 1989, the importer must have treated the sale of the television receivers as the first sale or use of the printed circuits incorporated into the television receivers when reporting tax under section 4681 with respect to such printed circuits.

(d) *ODCs used as materials in the manufacture of imported taxable products*—(1) *ODC weight*. The tax imposed on an imported taxable product under section 4681 is computed by reference to the weight of the ODCs used as materials in the manufacture of the product (ODC weight). The ODC weight of a product includes the weight of ODCs used as materials in the manufacture of any components of the product.

(2) *ODCs used as materials in the manufacture of a product*. Except as provided in paragraph (d)(3) of this section, an ODC is used as a material in the manufacture of a product if the ODC is—

(i) Incorporated into the product;

(ii) Released into the atmosphere in the process of manufacturing the product; or

(iii) Otherwise used in the manufacture of the product (but only to the extent the cost of the ODC is properly allocable to the product).

(3) *Protective packaging*. ODCs used in the manufacture of the protective material in which a product is packaged are not treated as ODCs used as materials in the manufacture of such product.

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

Example 1. A, a manufacturer located outside the United States, uses ODCs as a solvent to clean the printed circuits it manufactures and as a coolant in the air-conditioning system of the factory in which the printed circuits are manufactured. The ODCs used as a solvent are released into the atmosphere, and, under paragraph (d)(2)(ii) of this section, are used as materials in the manufacture of the printed circuits. The ODCs used as a coolant in the air-conditioning system are also used in the manufacture of the printed circuits. Under paragraph (d)(2)(iii) of this section, these ODCs are used as materials in the manufacture of the printed circuits only to the extent the cost of the ODCs is properly allocable to the printed circuits.

Example 2. B manufactures television receivers outside the United States and wraps them for shipping in a protective packing material manufactured with ODCs. Under paragraph (d)(3) of this section, the ODCs used in the manufacture of the protective packing material are not treated as ODCs used as a material in the manufacture of the television receivers.

(e) *Methods of determining ODC weight; computation of tax*—(1) *In general*. This paragraph (e) sets forth the methods to be used for determining the ODC weight of an imported taxable product and a method to be used in computing the tax when the ODC weight cannot be determined. The amount of tax is computed separately for each imported taxable product and the method to be used in determining the ODC weight or otherwise computing the tax is separately determined for each such product. Thus, an importer may use one method in computing the tax on some imported taxable products and different methods in computing the tax on other products. For example, an importer of telephone sets may compute the tax using the exact method described in paragraph (e)(2) of this section for determining the ODC weight of telephone sets supplied by one manufacturer and using the Table method described in paragraph (e)(3) of this section for telephone sets supplied by other manufacturers that have not provided sufficient information to allow the importer to use the exact method.

(2) *Exact method*. If the importer determines the weight of each ODC used as a material in the manufacture of an imported taxable product and supports that determination with sufficient and reliable information, the ODC weight of the product is the weight so determined. Under this method, the ODC weight of a mixture is equal to the weight of the ODCs contained in the mixture. Representations by the manufacturer of the product to the importer as to the weight of the ODCs used as materials in the manufacture of the product may be sufficient and reliable information for this purpose. Thus, a letter to the importer signed by the manufacturer may constitute sufficient and reliable information if the letter adequately identifies the product and states the weight of each ODC used as a material in the product's manufacture.

(3) *Table method*—(i) *In general*. If the ODC weight of an imported taxable product is not determined using the exact method described in paragraph (e)(2) of this section and the current Table specifies an ODC weight for the product, the ODC weight of the product is the Table ODC weight, regardless of what ODCs were used in the manufacture of the product. In computing the amount of tax, the Table ODC weight shall not be rounded.

(ii) *Special rules*—(A) *Articles assembled in the United States*. An importer that assembles finished articles in the United States may compute the amount of tax imposed on the imported taxable products incorporated into the finished article by using the Table ODC weight specified for the article instead of the Table ODC weights specified for the components. In order to compute the tax under this special rule, the importer must determine the actual number of articles manufactured. For example, if an importer manufactures 100 camcorders using imported subassemblies, the importer may compute the amount of tax on the subassemblies by using the Table ODC weight specified for camcorders. Thus, the tax imposed on the subassemblies is equal to the tax that would be imposed on 100 camcorders.

(B) *Combination method*. This paragraph (e)(3)(ii)(B) applies to an imported taxable product if the current Table specifies weights for two or more ODCs with respect to the product and the importer of the product can determine the weight of any such ODC (and of any ODC used as a substitute for such ODC) and can support such determination with sufficient and reliable information. In determining the ODC weight of any such product, the importer may replace the weight specified in the Table for such ODC with the weight (as determined by the importer) of such ODC and its substitutes. For example, if an importer has sufficient and reliable information to determine the amount of CFC–12 included in a product as a coolant (and to determine that no ODCs have been used as substitutes for CFC–12) but cannot determine the amount of CFC–113 used in manufacturing the product's electronic components, the importer may use the weight specified in the Table for CFC–113 and the actual weight determined by the importer for CFC–12 in determining the ODC weight of the product.

(C) *ODCs used in the manufacture of rigid foam insulation*. In computing the tax using the method described in this paragraph (e)(3), any ODC for which the Table specifies a weight followed by an asterisk (*) shall be treated as an ODC used in the manufacture of rigid foam insulation (as defined in § 52.4682–1(d)(3) and (4)).

(4) *Value method*—(i) *General rule*. If the importer cannot determine the ODC weight of an imported taxable product under the exact method described in paragraph (e)(2) of this section and the Table ODC weight of the product is not specified, the tax imposed on the product under section 4681 is one percent of the entry value of the product.

(ii) *Special rule for mixtures*. If, in the case of an imported taxable product that is a mixture, the tax was determined under the method described in this paragraph (e)(4), the Commissioner may redetermine the tax based on the ODC weight of the mixture.

(5) *Adjustment for prior taxes*—(i) *In general*. If any manufacture with respect to an imported taxable product occurred in the United States or the product incorporates a taxed component or a taxed chemical was used in its manufacture, the product's ODC weight (or value) attributable to manufacture within the United States or to taxed components or taxed chemicals shall be disregarded in computing the tax on such product using a method described in paragraph (e) (2), (3), or (4) of this section.

(ii) *Taxed component*. The term ''taxed component'' means any component that previously was subject to tax as an imported taxable product or that would have been so taxed if section 4681 had been in effect for periods before January 1, 1990.

(iii) *Taxed chemical*. The term ''taxed chemical'' means any ODC that previously was subject to tax.

(6) *Examples*. The application of this paragraph (e) may be illustrated by the following examples:

Example 1. A is an importer (as defined in § 52.4681–1(c)(5)) of VCRs. The HTS classification for the VCRs is 8528.10.40. VCRs classified under HTS heading 8528.10.40 are imported taxable products because they are listed in the Table (contained in paragraph (f)(6) of this section) by name and HTS heading (as described in paragraph (f)(3)(i) of this section). Each VCR is wrapped in protective packing material manufactured with ODCs. A imports and sells 100 VCRs during the first calendar quarter of 1991. A may determine the ODC weight for the VCRs by reference to the Table. The Table ODC weight specified for VCRs classified under HTS heading 8528.10.40 is 0.0586 pound of CFC–113. This weight does not take protective packaging into account. The amount of tax for the first quarter of 1991 is $6.42 (0.0586 (the ODC weight) × 100 (the number of VCRs sold in the quarter) × $1.37 (the base tax amount for CFC–113 in 1991) × 0.8 (the ozone-depletion factor for CFC–113)). If A uses the exact method (as described in paragraph (e)(2) of this section) to determine the ODC weight for the VCRs, A does not take into account the ODCs used in the manufacture of the protective packaging. (Imported protective packaging containing foams made with ODCs other than foams defined in § 52.4682–1(d)(3) is subject to tax, however, if the packaging is sold as packaging or first used as packaging in the United States.)

Example 2. The facts are the same as in *Example 1*, except that A's VCRs are manufactured using methyl chloroform as the solvent instead of CFC–113. If A does not use the exact method to determine the weight of the methyl chloroform used in the manufacture of the VCRs, A must, under paragraphs (e)(3)(i) and (e)(4)(i) of this section, determine the ODC weight by reference to the Table. If A uses the Table ODC weight, the computation of tax is the same as in *Example 1*, using the base tax amount and ozone-depletion factor for CFC–113. A does not substitute the base tax amount and ozone-depletion factor of methyl chloroform for those of CFC–113.

Example 3. B imports and sells mixtures of ethylene oxide and CFC–12. The mixture is 88 percent CFC–12 by weight. B also imports and sells R–502. The R–502 is 51 percent CFC–115 by weight. In the first calendar quarter of 1991 B sells 100 pounds of imported ethylene oxide/CFC–12 mixture and 10,000 pounds of imported R–502. The ethylene/CFC–12 mixture and the R–502 are imported taxable products because they are listed in Part I of the Table (contained in paragraph (f)(6) of this section). Under the exact method described in paragraph (e)(2) of this section, B computes the tax based on 88 pounds of CFC–12, the amount of ODCs contained in the imported ethylene oxide mixture, and based on 5100 pounds of CFC–115, the amount of ODCs in the imported R–502.

(f) *Imported Products Table*—(1) *In general*. This paragraph (f) contains rules relating to the Imported Products Table (Table) and sets forth the Table. The Table lists all the products that are subject to the tax on imported taxable products and specifies the Table ODC weight of each product for which such a weight has been determined.

(2) *Applicability of Table*—(i) *In general*. Except as provided in paragraph (f)(2)(ii) of this section, the Table contained in paragraph (f)(6) of this section is effective on January 1, 1990.

(ii) *Treatment of certain products*—(A) Products included in a listing that is preceded by a double asterisk (**) in the Table shall not be treated as imported taxable products until October 1, 1990.

(B) Products included in a listing that is preceded by a triple asterisk (***) in the Table shall not be treated as imported taxable products until January 1, 1992.

(3) *Identification of products*—(i) *In general*. Each listing in the Table identifies a product by name and includes only products that are described by that name. Most listings (other than listings for mixtures) identify a product by both name and HTS heading. In such cases, a product is included in that listing only if the product is described by that name and the rate of duty on the product is determined by reference to that HTS heading. However, the product is included in that listing even if it is manufactured with or contains a different ODC than the ODC specified in the Table.

(ii) *Electronic items not listed by specific name*—(A) *In general*. Part II of the Table contains listings for electronic items that are not included within any other listing in the Table. An imported product is included in these listings only if such imported product—

(*1*) Is an electronic component listed in chapters 84, 85, or 90 of the Harmonized Tariff Schedule; or

(*2*) Contains components described in paragraph (f)(3)(ii)(A)(*1*) of this section and more than 15 percent of the cost of the imported product is attributable to such components.

(B) *Electronic component*. For purposes of this paragraph (f)(3)(ii), an electronic component is a component

whose operation involves the use of nonmechanical amplification or switching devices such as tubes, transistors, and integrated circuits. Such components do not include passive electrical devices such as resistors and capacitors.

(C) *Certain items not included.* Items such as screws, nuts, bolts, plastic parts, and similar specially fabricated parts that may be used to construct an electronic item are not themselves included in the listing for electronic items not otherwise listed in the Table.

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

Example 1. The Table lists ''electronic integrated circuits and microassemblies; HTS heading 8542.'' A bipolar transistor under HTS heading 8542.11.00.05 is included in this listing because a bipolar transistor is a type of electronic integrated circuit and HTS heading 8542.11.00.05 is included within HTS heading 8542.

Example 2. The Table lists ''radios; HTS heading 8527.19,'' ''radio combinations; HTS heading 8527.11'' and ''radio combinations; HTS heading 8527.31.'' A radio classified under HTS heading 8527.19 is not included within either listing for radio combinations. However, a radio classified under HTS heading 8527.19.00.20 is included within the listing for radios; HTS heading 8527.19. A radio combination classified under HTS heading 8527.11.20 is included within the listing for radio combinations; HTS heading 8527.11 but not the listing for radio combinations; HTS heading 8527.31. Any radio or radio combination not classified under the HTS heading for any other listing is included in the listing for electronic items not otherwise listed.

(4) *Rules for listing products.* Products are listed in the Table in accordance with the following rules:

(i) *Listing in part I.* A product is listed in part I of the Table if it is a mixture containing ODCs. In addition, a product other than a mixture containing ODCs will be listed in part I of a revised Table if the Commissioner has determined that—

(A) The ODC weight of the product is not *de minimis* when the product is produced using the predominant method of manufacturing the product; and

(B) None of the ODCs used as materials in the manufacture of the product under the predominant method are used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

(ii) *Listing in part II.* A product is listed in part II of the Table if the Commissioner has determined that the ODCs used as materials in the manufacture of the product under the predominant method are used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

(iii) *Listing in part III.* A product is listed in part III of the Table if the Commissioner has determined that the product is not an imported taxable product and the product would otherwise be included within a listing in part II of the Table. For example, floppy disk drive units are listed in part III because they are not imported taxable products and they would, but for their listing in part III, be included within the part II listing for electronic items not specifically identified.

(5) *Table ODC weight.* The Table ODC weight of a product is the weight, determined by the Commissioner, of the ODCs that are used as materials in the manufacture of the product under the predominant method of manufacturing. The Table ODC weight is given in pounds per single unit of product unless otherwise specified.

(6) *Table.* The Table is set forth below:

IMPORTED PRODUCTS TABLE

Product name	Harmonized tariff schedule heading	ODC	ODC weight
Part I—Products that are mixtures containing ODCs:			
Mixtures containing ODCs, including but not limited to:			
—anti-static sprays.			
—automotive products such as ''carburetor cleaner,'' ''stop leak,'' and ''oil charge''.			
—cleaning solvents.			
—contact cleaners.			
—degreasers.			

IMPORTED PRODUCTS TABLE—Continued

Product name	Harmonized tariff schedule heading	ODC	ODC weight
—dusting sprays.			
—electronic circuit board coolants.			
—electronic solvents.			
—ethylene oxide/CFC–12.			
—fire extinguisher preparations and charges.			
—flux removers for electronics.			
—insect and wasp sprays.			
—mixtures of ODCs.			
—propellants.			
—refrigerants			

Product name	Harmonized tariff schedule heading	ODC	ODC weight
Part II—Products in which ODCs are used for purposes of refrigeration or air conditioning, creating an aerosol or form or manufacturing electronic components:			
Rigid foam insulation defined in §52.4682–1(d)(3)			
Foams made with ODCs, other than foams defined in §52.4682–1(d)(3).			
Scrap flexible foams made with ODCs			
Medical products containing ODCs:			
Surgical staplers			
Cryogenic medical instruments			
Drug delivery systems			
Inhalants			
Dehumidifiers, household	8415.82.00.50	CFC–12	0.344
Chillers:	8415.82.00.65		
Charged with CFC–12		CFC–12	1600.
Charged with CFC–114		CFC–114	1250.
Charged with R–500		CFC–12	1920.
Refrigerator-freezers, household:			
Not > 184 liters	8418.10.00.10	CFC–11	[1]1.08
		CFC–12	0.13
> 184 liters but not > 269 liters	8418.10.00.20	CFC–11	[1]1.32
		CFC–12	0.26
> 269 liters but not > 382 liters	8418.10.00.30	CFC–11	[1]1.54
		CFC–12	0.35
> 382 liters	8418.10.00.40	CFC-11	[1]1.87
		CFC–12	0.35
Refrigerators, household:			
Not > 184 liters	8418.21.00.10	CFC–11	[1]1.08
		CFC–12	0.13
> 184 liters but not > 269 liters	8418.21.00.20	CFC–11	[1]1.32
		CFC–12	0.26
> 269 liters but not > 382 liters	8418.21.00.30	CFC–11	[1]1.54
		CFC–12	0.35
> 382 liters	8418.21.00.90	CFC–11	[1]1.87
		CFC–12	0.35
Freezers, household	8418.30	CFC–11	[1]2.0
		CFC–12	0.4
Freezers, household	8418.40	CFC–11	[1]2.0
		CFC–12	0.4
Refrigerating display counters not > 227 kg	8418.50	CFC–11	[1]50.0
		CFC–12	260.0
Icemaking machines	8418.69		
Charged with CFC–12		CFC–12	1.4
Charged with R–502		CFC–115	3.39
Drinking water coolers	8418.69		
Charged with CFC–12		CFC–12	0.21
Charged with R–500		CFC–12	0.22
Centrifugal chillers, hermetic	8418.69		
Charged with CFC–12		CFC–12	1600.
Charged with CFC–114		CFC–114	1250.
Charged with R–500		CFC–12	1920.
Reciprocating chillers	8418.69		
Charged with CFC–12		CFC–12	200.
Mobile refrigeration systems	8418.99		
Containers		CFC–12	15.

Product name	Harmonized tariff schedule heading	ODC	ODC weight
Trucks		CFC–12	11.
Trailers		CFC–12	20.
Refrigeration condensing units:			
not > 746W	8418.99.00.05	CFC–12	0.3
> 746W but not > 2.2KW	8418.99.00.10	CFC–12	1.0
> 2.2KW but not > 7.5KW	8418.99.00.15	CFC–12	3.0
> 7.5KW but not > 22.3KW	8418.99.00.20	CFC–12	8.5
> 22.3 KW	8418.99.00.25	CFC–12	17.0
Fire extinguishers, charged w/ODCs	8424		
Electronic typewriters and word processors	8469	CFC–113	0.2049
Electronic calculators	8470.10	CFC–113	0.0035
Electronic calculators w/printing device	8470.21	CFC–113	0.0057
Electronic calculators	8470.29	CFC–113	0.0035
Account machines	8470.40	CFC–113	0.1913
Cash registers	8470.50	CFC–113	0.1913
Digital automatic data processing machines w/cathode ray tube, not included in subheading 8471.20.00.90.	8471.20	CFC–113	0.3663
Laptops, notebooks, and pocket computers	8471.20.00.90	CFC–113	0.03567
Digital processing units w/entry value:			
Not > $100K	8471.91	CFC–113	0.4980
> $100K	8471.91	CFC–113	27.6667
Combined input/output units (terminals)	8471.92	CFC–113	0.3600
Keyboards	8471.92	CFC–113	0.0742
Display units	8471.92	CFC–113	0.0386
Printer units	8471.92	CFC–113	0.1558
Input or output units	8471.92	CFC–113	0.1370
Hard magnetic disk drive units not included in subheading 8471.93.10 for a disk of a diameter:			
Not > 9 cm (3½ inches)	8471.93	CFC–113	0.2829
> 9 cm (3½ inches) but not > 21 cm (8¼ inches)	8471.93	CFC–113	1.1671
Nonmagnetic storage units w/ entry value > $1,000	8471.93	CFC–113	2.7758
Magnetic disk drive units for a disk of a diameter over 21 cm (8¼ inches).	8471.93.10	CFC–113	4.0067
Power supplies	8471.99.30	CFC–113	0.0655
Electronic office machines	8472	CFC–113	0.001
Populated cards for digital processing units in subheading 8471.91 w/value:			
Not > $100K	8473.30	CFC–113	0.1408
> $100K	8473.30	CFC–113	4.82
Automatic goods-vending machines with refrigerating device	8476.11	CFC–12	0.45
Microwave ovens with electronic controls, with capacity of	8516.50		
0.99 cu. ft. or less		CFC–113	0.0300
1.0 through 1.3 cu. ft		CFC–113	0.0441
1.31 cu. ft. or greater		CFC–113	0.0485
Microwave oven combinations with electronic controls	8516.60.40.60	CFC–113	0.0595
Telephone sets w/entry value:			
Not > $11.00	8517.10	CFC–113	0.0225
> $11.00	8517.10	CFC–113	0.1
Teleprinters and teletypewriters	8517.20	CFC–113	0.1
Switching equipment not included in subheading 8517.30.20	8517.30	CFC–113	0.1267
Private branch exchange switching equipment	8517.30.20	CFC–113	0.0753
Modems	8517.40	CFC–113	0.0225
Intercoms	8517.81	CFC–113	0.0225
Facsimile machines	85l7.82	CFC–113	0.0225
Loudspeakers, microphones, headphones, and electric sound amplifier sets, not included in subheading 8518.30.10.	8518	CFC–113	0.0022
Telephone handsets	8518.30.10	CFC–113	0.042
Turntables, record players, cassette players, and other sound reproducing apparatus.	8519	CFC–113	0.0022
Magnetic tape recorders and other sound recording apparatus, not included in subheading 8520.20.	8520	CFC–113	0.0022
Telephone answering machines	8520.20	CFC–113	0.1
Color video recording/reproducing apparatus	8521.10.00.20	CFC–113	0.0586
Videodisc players	8521.90	CFC–113	0.0106
Cordless handset telephones	8525.20.50	CFC–113	0.1
Cellular communication equipment	8525.20.60	CFC–113	0.4446
TV cameras	8525.30	CFC–113	1.423
Camcorders	8525.30	CFC–113	0.0586
Radio combinations	8527.11	CFC–113	0.0022
Radios	8527.19	CFC–113	0.0014
Motor Vehicle radios with or w/o tape player	8527.21	CFC–113	0.0021
Radio combinations	8527.31	CFC–113	0.0022

Product name	Harmonized tariff schedule heading	ODC	ODC weight
Radios	8527.32	CFC–113	0.0014
Tuners w/o speaker	8527.39.00.20	CFC–113	0.0022
Television receivers	8528	CFC–113	0.0386
VCRs	8528.10.40	CFC–113	0.0586
Home satellite earth stations	8528.10.80.55	CFC–113	0.0106
Electronic assemblies for HTS headings 8525, 8527, & 8528	8529.90	CFC–113	0.0816
Indicator panels incorporating liquid crystal devices or light emitting diodes.	8531.20	CFC–113	0.0146
Printed circuits	8534	CFC–113	0.001
Computerized numerical controls	8537.10.00.30	CFC–113	0.1306
Diodes, crystals, transistors and other similar discrete semiconductor devices.	8541	CFC–113	0.0001
Electronic integrated circuits and microassemblies	8542	CFC–113	0.0002
Signal generators	8543.20	CFC–113	0.6518
Avionics	8543.90.40	CFC–113	0.915
Signal generators subassemblies	8543.90.80	CFC–113	0.1265
Insulated or refrigerated railway freight cars	8606	CFC–11	[1]100.
Passenger automobiles	8703		
Foams (interior)		CFC–11	0.8
Foams (exterior)		CFC–11	0.7
With charged a/c		CFC–12	2.0
Without charged a/c		CFC–12	0.2
Electronics		CFC–113	0.5
Light trucks	8704		
Foams (interior)		CFC–11	0.6
Foams (exterior)		CFC–11	0.1
With charged a/c		CFC–12	2.0
Without charged a/c		CFC–12	0.2
Electronics		CFC–113	0.4
Heavy trucks and tractors, GVW 33,001 lbs or more:[2]	8704		
Foams (interior)		CFC–11	0.6
Foams (exterior)		CFC–11	0.1
With charged a/c		CFC–12	3.0
Without charged a/c		CFC–12	0.2
Electronics		CFC–113	0.4
Motorcycles with seat foamed with ODCs	8711	CFC–11	0.04
Bicycles with seat foamed with ODCs	8712	CFC–11	0.04
Seats foamed with ODCs	8714.95	CFC–11	0.04
Aircraft	8802	CFC–12	0.25 lb/1000 lbs Operating Empty Weight (OEW).
		CFC–113	30.0 lbs./1000 lbs.OEW
Optical fibers	9001	CFC–12	0.005 lb/thousand feet.
Electronic cameras	9006	CFC–113	0.01
Photocopiers	9009	CFC–113	0.0426
Avionics	9014.20	CFC–113	0.915
Electronic drafting machines	9017	CFC–113	0.12
Complete patient monitoring systems	9018.19.80	CFC–12	0.94
		CFC–113	3.4163
Complete patient monitoring systems; subassemblies thereof	9018.19.80.60	CFC–113	1.9320
Physical or chemical analysis instruments	9027	CFC–12	0.0003
		CFC–113	0.0271
Oscilloscopes	9030	CFC–11	0.49
		CFC–12	0.5943
		CFC–113	0.2613
Foam chairs	9401	CFC–11	0.30
Foam sofas	9401	CFC–11	0.75
Foam mattresses	9404.21	CFC–11	1.60
Electronic games and electronic components thereof	9504	CFC-113	
Electronic items not otherwise listed in the Table:			
Included in HTS chapters 84, 85, 90		CFC–113	0.0004 pound/$1.00 of entry value.
Not included in HTS chapters 84, 85, 90[3]		CFC–113	0.0004 pound/$1.00 of entry value.
PART III—Products that are not Imported Taxable Products:			
Room air conditioners	8415.10.00.60		
Dishwashers	8422.11		
Clothes washers	8450.11		
Clothes dryers	8451.21		
Floppy disk drive units	8471.93		

Product name	Harmonized tariff schedule heading	ODC	ODC weight
Transformers and inductors	8504		
Toasters	8516.72		
Unrecorded media	8523		
Recorded media	8524		
Capacitors	8532		
Resistors	8533		
Switching apparatus	8536		
Cathode tubes	8540		

[1] See paragraph (e)(3)(ii)(C) of this section. Denotes an ODC used in the manufacture of rigid foam insulation.
[2] See paragraph (f)(2)(ii)(A) of this section. Denotes product for which the effective date is October 1, 1990.
[3] See paragraph (f)(2)(ii)(B) of this section. Denotes products for which the effective date is January 1, 1992.

(g) *Requests for modification of Table*—(1) *In general*. Any manufacturer or importer of a product may request that the Secretary modify the Table in any of the following respects:

(i) Adding a product to the Table and specifying its Table ODC weight.

(ii) Removing a product from the Table.

(iii) Changing or specifying the Table ODC weight of a product.

(2) *Form of request*. The Secretary will consider a request for modification that includes the following:

(i) The name, address, taxpayer identifying number, and principal place of business of the requester.

(ii) For each product with respect to which a modification is requested:

(A) The name of the product;

(B) The HTS heading or subheading;

(C) The type of modification requested;

(D) The Table ODC weight that should be specified for the product if the request relates to adding a product or changing or specifying its Table ODC weight; and

(E) The data supporting the request.

(3) *Address*. The address for submission of requests under this paragraph (g) is: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (Imported Products Table), room 5228, Washington, DC 20044.

(4) *Public inspection and copying*. Requests submitted under this paragraph (g) will be available in the Internal Revenue Service Freedom of Information Reading Room for public inspection and copying.

[T.D. 8370, 56 FR 56311, Nov. 4, 1991, as amended by T.D. 8370, 58 FR 14518, Mar. 18, 1993]

§ 52.4682–4 Floor stocks tax.

(a) *Overview*. This section provides rules for identifying ozone-depleting chemicals (ODCs) that are subject to the floor stocks tax imposed by section 4682(h)(1), determining the person that is liable for the tax, and computing the amount of the tax. See § 52.4681–1(a)(3) and (c) for general rules and definitions relating to the floor stocks tax.

(b) *Identifying rules*—(1) *ODCs subject to floor stocks tax; ODCs held for sale or for use in further manufacture*—(i) *In general*. The floor stocks tax is imposed only on an ODC that is held for sale or for use in further manufacture on the date the tax is imposed. This paragraph (b)(1) provides rules for identifying ODCs held for sale or for use in further manufacture.

(ii) *Held for sale*—(A) *In general*. For purposes of determining whether an ODC is held for sale, the term *sale* shall have the meaning set forth in § 52.4681–1(c)(6). ODCs held for sale include ODCs that will be sold in connection with the provision of services or in connection with the sale of a manufactured article and, in such cases, include ODCs that will be sold without the statement of a separate charge for those ODCs.

(B) *ODCs held by a government*. An ODC that is held by a government for its own use is not held for sale even if the ODC will be transferred between agencies or other subdivisions that have or are required to have different employer identification numbers.

(iii) *Held for use in further manufacture*. Except as otherwise provided in paragraph (b)(2)(v) of this section, an ODC is held for use in further manufacture if—

(A) The ODC will be used as a material (within the meaning of paragraph

(b)(1)(iv) of this section) in the manufacture of an article; and

(B) Such article will be held for sale.

(iv) *Use as material*—(A) *In general*. Except as provided in paragraph (b)(1)(iv)(B) of this section, an ODC will be used as a material in the manufacture of an article if the ODC will be—

(*1*) Incorporated into the article; or

(*2*) Released into the atmosphere in the process of manufacturing the article.

(B) *ODCs used in equipment*. For purposes of the floor stocks tax, an ODC is not used as a material in the manufacture of an article if the ODC is (or will be) contained in equipment used in such manufacture and the ODC will be used for its intended purpose without being released from such equipment. Thus, ODCs that are (or will be) used as coolants in a factory's air-conditioning system are not used as materials in the manufacture of articles produced in the factory.

(v) *Storage containers*. The floor stocks tax is imposed on an ODC without regard to the type or size of the storage container in which the ODC is held. Thus, the tax may apply to an ODC whether it is in a 14-ounce can or a 30-pound tank.

(vi) *Examples*. The provisions of this paragraph (b)(1) may be illustrated by the following examples:

Example 1. A, a manufacturer of air conditioners, holds an ODC for use in air conditioners that it will manufacture and sell. A holds the ODC for use in further manufacture.

Example 2. B, a manufacturer of electronic components, holds an ODC for use as a solvent to clean printed circuits that it will sell to computer manufacturers. B holds the ODC for use in further manufacture.

Example 3. C, an automobile dealer, holds an ODC for use in charging air conditioners installed in automobiles that it sells to retail customers. C does not hold the ODC for use in further manufacture. C does, however, hold the ODC for sale, even if the customers are not separately charged for ODCs used in the automobile air conditioners.

Example 4. D operates an air-conditioning repair service and holds an ODC for use in repairing air conditioners for its customers. D holds the ODC for sale even if the customers are not separately charged for ODCs used in the repairs.

Example 5. E, a grocery-store chain, holds an ODC for use in its refrigeration units. E does not hold the ODC for sale or for use in further manufacture.

Example 6. F, a bank, holds an ODC for use in its fire extinguishers to protect the computer system. F does not hold the ODC for sale or for use in further manufacture.

Example 7. G, a government agency, holds an ODC for use in the refrigeration equipment of its various units. The units have separate employer identification numbers. The ODC is stored in a central warehouse until needed by a unit and then transferred to the unit upon request. G does not hold the ODC for sale or for use in further manufacture.

(2)(i) *Mixtures*—(A) *Tax imposed on January 1, 1990*. In the case of the floor stocks tax imposed on January 1, 1990, the tax is not imposed on an ODC that has been mixed with any other ingredients.

(B) *Taxes imposed after 1990*—(*1*) *In general*. In the case of the floor stocks tax imposed on January 1 of a calendar year after 1990, the tax is not imposed on an ODC that has been mixed with any other ingredients, but only if it is established that such ingredients contribute to the accomplishment of the purpose for which the mixture will be used. A mixture is not exempt from tax under this paragraph (b)(2)(i)(B), however, if it contains only an ODC and an inert ingredient that does not contribute to the accomplishment of the purpose for which the mixture will be used.

(*2*) *Exception*. In the case of a floor stocks tax imposed on or after January 1, 1992, a mixture is not exempt from floor stocks tax under this paragraph (b)(2)(i)(B) if it contains only ODCs and one or more stabilizers. For this purpose, the term *stabilizer* means an ingredient needed to maintain the chemical integrity of the ODC.

(C) *Examples*. The provisions of this paragraph (b)(2)(i) may be illustrated by the following examples:

Example 1. The floor stocks tax is not imposed on the ODCs contained in refrigerants such as R–500 and R–502 because such products are mixtures of ODCs and other chemicals that contribute to the accomplishment of the purpose for which the mixture will be used.

Example 2. The floor stocks tax is not imposed on the ODCs contained in automotive products used for checking for leaks because such products are a mixture of ODCs and

small amounts of dyes and oils that contribute to the accomplishment of the purpose for which the mixture will be used.

Example 3. The floor stocks tax is not imposed on Halon 1301 pressurized with nitrogen. Although nitrogen is an inert ingredient, it contributes to the accomplishment of the purpose for which the mixture will be used.

Example 4. On January 1, 1993, the floor stocks tax is imposed on methyl chloroform that is stabilized to prevent hydrolization or chemical reaction during transportation or use, unless the stabilized methyl chloroform has also been mixed with other ingredients that contribute to the accomplishment of the purpose for which the mixture will be used.

(ii) *Manufactured articles.* The floor stocks tax is not imposed on an ODC that is contained in a manufactured article in which the ODC will be used for its intended purpose without being released from such article. For example, the tax is not imposed on the ODCs contained in the cooling coils of a refrigerator even if the refrigerator is held for sale. However, the tax is imposed on a can of ODC used to recharge an air conditioning unit because the ODC must be expelled from the can in order to be used. Similarly, beginning in 1991, the tax is imposed on Halons contained in a fire extinguisher held for sale because such ODCs must be expelled from the fire extinguisher in order to be used.

(iii) *Recycled ODCs.* The floor stocks tax is not imposed on ODCs that have been reclaimed or recycled. For example, the tax is not imposed on an ODC that is held for use in further manufacture after being used as a solvent and recycled.

(iv) *ODCs held by the manufacturer or importer.* The floor stocks tax is not imposed on ODCs held by their manufacturer or importer.

(v) *ODCs used as a feedstock*—(A) *In general.* The floor stocks tax is not imposed on any ODC that was sold in a qualifying sale for use as a feedstock (as defined in § 52.4682–1(c)).

(B) *Post-1989 ODCs sold before January 1, 1990; post-1990 ODCs sold before January 1, 1991.* A post-1989 ODC that was sold by its manufacturer or importer before January 1, 1990, or a post-1990 ODC that was sold by its manufacturer or importer before January 1, 1991, shall be treated, for purposes of this paragraph (b)(2)(v), as an ODC that was sold in a qualifying sale for purposes of § 52.4682–1(c) if the ODC will be used as a feedstock (within the meaning of § 52.4682–2(c)(3)).

(vi) *ODCs to be exported*—(A) *In general.* The floor stocks tax is not imposed on any ODC that was sold in a qualifying sale for export (as defined in § 52.4682–5(d)(1)).

(B) *ODCs sold before January 1, 1993.* An ODC that was sold by its manufacturer or importer before January 1, 1993, is treated, for purposes of this paragraph (b)(2)(vi), as an ODC that was sold in a qualifying sale for export for purposes of § 52.4682–5(d)(1) if the ODC will be exported.

(vii) *ODCs used as propellants in metered-dose inhalers; years after 1992*—(A) *In general.* The floor stocks tax is not imposed on January 1 of calendar years after 1992 on any ODC that was sold in a qualifying sale for use as a propellant in a metered-dose inhaler (as defined in § 52.4682–1(h)).

(B) *ODCs sold before January 1, 1993.* An ODC that was sold by its manufacturer or importer before January 1, 1993, is treated, for purposes of this paragraph (b)(2)(vii), as an ODC that was sold in a qualifying sale for purposes of § 52.4682–1(h) if the ODC will be used as a propellant in a metered-dose inhaler (within the meaning of § 52.4682–1(h)).

(viii) *ODCs used as medical sterilants; 1993.* The floor stocks tax is not imposed in 1993 on any ODC held for use as a medical sterilant (as defined in § 52.4682–1(g)).

(c) *Person liable for tax*—(1) *In general.* The person liable for the floor stocks tax on an ODC is the person that holds the ODC on a date on which the tax is imposed. The person who holds the ODC is the person who has title to the ODC (whether or not delivery to such person has been made) as of the first moment of such date. The person who has title at such time is determined under applicable local law.

(2) *Special rule.* Each business unit that has, or is required to have, its own employer identification number is treated as a separate person for purposes of the floor stocks tax. For example, a chain of automotive parts stores that has one employer identification

number is one person for purposes of the floor stocks tax, and a parent corporation and subsidiary corporation that each have a different employer identification number are two persons for purposes of the floor stocks tax.

(d) *Computation of tax; tentative tax amount*—(1) *In general*—(i) *Generally applicable rules*. This paragraph (d) provides rules for determining the tentative tax amount and the amount of the floor stocks tax. Section 52.4681–1(a)(3) provides that the amount of the floor stocks tax on an ODC is determined by reference to a tentative tax amount. The tentative tax amount is the amount of tax that would be imposed on the ODC under section 4681(a)(1) if a sale of the ODC by the manufacturer or importer had occurred on the date the floor stocks tax is imposed. The amount of the floor stocks tax imposed on the ODCs contained in a nonexempt mixture is computed on the basis of the weight of the ODCs in that mixture.

(ii) *Floor stocks tax imposed on post-1989 ODCs on January 1, 1990*. The floor stocks tax imposed on post-1989 ODCs (as defined in § 52.4681–1(c)(9)) on January 1, 1990, is equal to the tentative tax amount. See paragraph (d)(2) of this section for rules relating to the floor stocks tax imposed on ODCs used in the manufacture of rigid foam insulation. See paragraph (d)(3) of this section for rules relating to the floor stocks tax imposed on Halons.

(iii) *Floor stocks tax imposed on post-1990 ODCs on January 1, 1991*. The floor stocks tax imposed on post-1990 ODCs (as defined in § 52.4681–1(c)(9)) on January 1, 1991, is equal to the tentative tax amount.

(iv) *Other floor stocks taxes*—(A) *In general*. The following rules apply for floor stocks taxes imposed on post-1989 ODCs after January 1, 1990, and on post-1990 ODCs after January 1, 1991:

(*1*) The tentative tax amount is determined, except as provided in paragraph (d)(2), (3), or (4) of this section, by reference to the rate of tax prescribed in section 4681(b)(1)(B) and the ozone-depletion factors prescribed in section 4682(b).

(*2*) The amount of the floor stocks tax on an ODC is equal to the amount by which the tentative tax amount exceeds the amount of taxes previously imposed on the ODC.

(B) *Example*. The application of this paragraph (d)(1)(iv) may be illustrated by the following example:

Example. The floor stocks tax imposed on one pound of CFC–12 held for sale on January 1, 1992, is $0.30 (the amount by which $1.67, the tentative tax, exceeds $1.37, the tax previously imposed on CFC–12).

(2) *ODCs used in the manufacture of rigid foam insulation; 1990, 1991, 1992, and 1993*—(i) *In general*. In the case of an ODC that was sold in a qualifying sale for purposes of § 52.4682–1(d) (relating to use in the manufacture of rigid foam insulation) the tentative tax amount is determined under section 4682(g) for purposes of computing the floor stocks tax imposed on the ODC on January 1, 1990, 1991, 1992 or 1993. For purposes of computing the floor stocks tax imposed on the ODC on January 1, 1990, the tentative tax amount is zero. The floor stocks tax is not imposed on ODCs for use in the manufacture of rigid foam insulation in 1992 and 1993.

(ii) *Post-1989 ODCs sold before January 1, 1990; post-1990 ODCs sold before January 1, 1991*. A post-1989 ODC that was sold by its manufacturer or importer before January 1, 1990, or a post-1990 ODC that was sold by its manufacturer or importer before January 1, 1991, shall be treated, for purposes of paragraphs (d)(2) and (e) of this section, as an ODC that was sold in a qualifying sale for purposes of § 52.4682–1(d) if the ODC will be used in the manufacture of rigid foam insulation (within the meaning of §§ 52.4682–1(d) (3) and (4)).

(3) *Halons; 1990, 1991, 1992, and 1993*. In the case of Halon-1211, Halon-1301, or Halon-2402 (Halons), the tentative tax amount is determined under section 4682(g) for purposes of computing the floor stocks tax imposed on Halons on January 1, 1990, 1991, 1992, or 1993. For purposes of computing the floor stocks tax imposed on Halons on January 1, 1990, the tentative tax amount is zero. The floor stocks tax is not imposed on Halons in 1992 and 1993.

(4) *Methyl chloroform; 1993*. In the case of methyl chloroform, the tentative tax amount is determined under section 4682(g)(5) for purposes of computing the floor stocks tax imposed on January 1, 1993.

(e) *De minimis exception*—(1) *1990 and 1992*. In the case of the floor stocks tax imposed on January 1, 1990 or 1992, a person is liable for the tax only if, on the date the tax is imposed, the person holds at least 400 pounds of post-1989 ODCs that are not described in paragraph (d) (2) or (3) of this section and are otherwise subject to tax.

(2) *1991*. In the case of the floor stocks tax imposed on January 1, 1991, a person is liable for the tax only if, on such date, the person holds at least 400 pounds of ODCs subject to the 1991 floor stocks tax. For this purpose, ODCs subject to the 1991 floor stocks tax are—

(i) Post-1990 ODCs that are subject to tax; and

(ii) Post-1989 ODCs that are described in paragraph (d) (2) or (3) of this section and are otherwise subject to tax.

(3) *1993*. In the case of the floor stocks tax imposed on January 1, 1993, a person is liable for the tax only if, on such date, the person holds at least 400 pounds of ODCs that are not described in paragraph (d) (2) or (3) of this section and are otherwise subject to tax.

(4) *1994*. In the case of the floor stocks tax imposed on January 1, 1994, a person is liable for the tax only if, on such date, the person holds—

(i) At least 400 pounds of ODCs that are not described in paragraph (d)(2) or (d)(3) of this section and are otherwise subject to tax;

(ii) At least 200 pounds of ODCs that are described in paragraph (d)(2) of this section and are otherwise subject to tax; or

(iii) At least 20 pounds of ODCs that are described in paragraph (d)(3) of this section and are otherwise subject to tax.

(5) *Calendar years after 1994*. In the case of the floor stocks tax imposed on January 1 of 1995 and each following calendar year, a person is liable for the tax only if, on such date, the person holds—

(i) At least 400 pounds of ODCs that are not described in paragraph (d)(3) or (d)(4) of this section and are otherwise subject to tax;

(ii) At least 50 pounds of ODCs that are described in paragraph (d)(3) of this section and are otherwise subject to tax; or

(iii) At least 1000 pounds of ODCs that are described in paragraph (d)(4) of this section and are otherwise subject to tax.

(6) *Examples*. The rules of this paragraph (e) may be illustrated by the following examples:

Example 1. On January 1, 1990, A holds for sale 300 pounds of CFC–12 (a post-1989 ODC not described in paragraph (d)(2) or (d)(3) of this section)) and 500 pounds of R–500 (a mixture). A does not hold at least 400 pounds of ODCs that are taken into account under paragraph (e)(1) of this section and, under paragraph (b)(2)(i) of this section, mixtures are not subject to the floor stocks tax. Thus, A is not liable for the floor stocks tax imposed on January 1, 1990.

Example 2. On January 1, 1990, B holds for sale 250 pounds of CFC–12 and 250 pounds of CFC–113 (post-1989 ODCs not described in paragraph (d) (2) or (3) of this section). B holds 500 pounds of ODCs that are taken into account under paragraph (e)(1) of this section. Thus, B is liable for the floor stocks tax imposed on January 1, 1990, because B holds at least 400 pounds of ODCs for sale.

Example 3. On January 1, 1990, C holds 200 pounds of post-1990 ODCs and 500 pounds of post-1989 ODCs for use in further manufacture. C will use 300 pounds of the post-1989 ODCs in the manufacture of rigid foam insulation (as defined in § 52.4682–1(d) (3) and (4)). The remainder of the ODCs are not described in paragraph (d) (2) or (3) of this section. Under paragraph (e)(1) of this section, post-1990 ODCs and ODCs that will be used in the manufacture of rigid foam insulation are disregarded in determining whether the *de minimis* exception is applicable in 1990. Thus, C holds only 200 pounds of ODCs that are taken into account under paragraph (e)(1) of this section and is not liable for the floor stocks tax imposed on January 1, 1990.

Example 4. (a) The facts are the same as in *Example 3*, except that the ODCs are held on January 1, 1991. Under paragraph (e)(2) of this section, the 200 pounds of post-1990 ODCs and the 300 pounds of post-1989 ODCs that will be used in the manufacture of rigid foam insulation are taken into account in determining whether the *de minimis* exception is applicable in 1991. Under paragraph (b)(2) of this section, the remaining 200 pounds of post-1989 ODCs are not taken into account because the base tax amount applicable to post-1989 ODCs does not increase in 1991. Thus, C holds 500 pounds of ODCs that are taken into account under paragraph (e)(2) of this section and is liable for the floor stocks tax imposed on January 1, 1991.

(b) The amount of the floor stocks tax imposed on the 200 pounds of post-1990 ODCs and the 300 pounds of post-1989 ODCs that will be used in the manufacture of rigid foam

insulation is equal to the tentative tax amount because those ODCs were not previously subject to tax.

Example 5. (a) On January 1, 1994, D holds for sale 300 pounds of CFC–113 (an ODC not described in paragraph (d)(2) or (d)(3) of this section) and 25 pounds of Halon-1301 (an ODC described in paragraph (d)(3) of this section). D is liable for the floor stocks tax imposed on January 1, 1994, because 25 pounds of Halon-1301 exceeds the de minimis amount specified in paragraph (e)(4)(iii) of this section. The 300 pounds of CFC–113 is less than the amount specified in paragraph (e)(4)(i) of this section. Nevertheless, tax is imposed on both the 25 pounds of Halon-1301 and the 300 pounds of CFC–113.

(b) The amount of the floor stocks tax is determined separately for the 300 pounds of CFC–113 and the 25 pounds of Halon-1301 and is equal to the difference between the tentative tax amount and the amount of tax previously imposed on those ODCs. For Halon-1301, for example, the tax is determined as follows. The tentative tax amount is $1,087.50 ($4.35 (the base tax amount in 1994) × 10 (the ozone-depletion factor for Halon-1301) × 25 (the number of pounds held)). The tax previously imposed on the Halon-1301 is $6.28 ($3.35 (the base tax amount in 1993) × 10 (the ozone-depletion factor for Halon-1301) × 0.75 percent (the applicable percentage determined under section 4682(g)(2)(A)) × 25 (the number of pounds held)). Thus, the floor stocks tax imposed on the 25 pounds of Halon-1301 in 1994 is $1,081.22, the difference between $1,087.50 (the tentative tax amount) and $6.28 (the tax previously imposed).

(f) *Inventory*—(1) *In general.* If, on the date on which the floor stocks tax is imposed, a person holds ODCs for sale or for use in further manufacture and the ODCs were not manufactured or imported by such person, the following rules apply:

(i) The person shall prepare an inventory of all such ODCs that the person holds on the date on which the tax is imposed.

(ii) The inventory shall be taken as of the first moment of the date on which the tax is imposed, but work-back or work-forward inventories will be acceptable if supported by adequate commercial records of receipt, use, and disposition of ODCs held for sale or for use in further manufacture.

(iii) The person must maintain records of the inventory and make such records available for inspection and copying by internal revenue agents and officers. Records of the inventory are not to be filed with the Internal Revenue Service.

(2) *Circumstances in which an inventory is not required.* The inventory requirement of paragraph (f)(1) of this section does not apply to any person holding, on a date on which floor stocks tax is imposed, only ODCs that are not subject to tax by reason of a statutory exemption (e.g., use as a feedstock) or regulatory exclusion other than the *de minimis* exception provided by paragraph (e) of this section (e.g., mixtures). In addition, any person that holds ODCs subject to the floor stocks tax and also holds ODCs that are nontaxable under the provisions of paragraph (b)(2) of this section, is not required to inventory the nontaxable ODCs. However, any person that holds any ODCs that either are subject to the floor stocks tax or would be subject to the floor stocks tax but for the *de minimis* exception must inventory those ODCs.

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

Example 1. On January 1, 1990, A holds for sale 300 pounds of CFC–12 (a post-1989 ODC not described in paragraph (d)(2) or (d)(3) of this section) and 500 pounds of R–500 (a mixture). As required by paragraph (f)(1) of this section, A must prepare an inventory of the CFC–12 A holds for sale on that date even though, under paragraph (e)(1) of this section, the 300 pounds of CFC–12 is not taken into account because it is *de minimis*. However, as provided in paragraph (f)(2) of this section, A is not required to inventory the R–500 because, under paragraph (b)(2) of this section, mixtures are not subject to the floor stocks tax.

Example 2. On January 1, 1991, B holds for sale 1,000 pounds of CFC–12 (a post-1989 ODC not described in paragraph (d)(2) or (d)(3) of this section). As provided under paragraph (f)(2) of this section, B is not required to prepare an inventory because CFC–12 is not subject to the floor stocks tax in 1991.

(g) *Time for paying tax.* The floor stocks tax imposed under section 4682(h) shall be paid without assessment or notice. In the case of the floor stocks tax imposed on January 1, 1990, the tax shall be paid by April 1, 1990. In the case of floor stocks taxes imposed after January 1, 1990, the tax shall be

paid by June 30 of the year in which the tax is imposed.

[T.D. 8370, 56 FR 56317, Nov. 4, 1991, as amended by T.D. 8622, 60 FR 52852, Oct. 11, 1995]

§ 52.4682–5 Exports.

(a) *Overview*. This section provides rules relating to the tax imposed under section 4681 on ozone-depleting chemicals (ODCs) that are exported. In general, tax is not imposed on ODCs that a manufacturer or importer sells for export, or for resale by the purchaser to a second purchaser for export, if the procedural requirements set forth in paragraph (d) of this section are met. The tax benefit of this exemption is limited, however, to the manufacturer's or importer's exemption amount. Thus, if the tax that would otherwise be imposed under section 4681 on ODCs that a manufacturer or importer sells for export exceeds this exemption amount, a tax equal to the excess is imposed on the ODCs. The exemption amount, which is determined separately for post-1989 ODCs and post–1990 ODCs, is calculated for each calendar year in accordance with the rules of paragraph (c) of this section. This section also provides rules under which a tax imposed under section 4681 on exported ODCs may be credited or refunded, subject to the same limit on tax benefits, if the procedural requirements set forth in paragraph (f) of this section are met. See § 52.4681–1(c) for definitions relating to the tax on ODCs.

(b) *Exemption or partial exemption from tax*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, no tax is imposed on an ODC if the manufacturer or importer of the ODC sells the ODC in a qualifying sale for export (within the meaning of paragraph (d)(1) of this section).

(2) *Tax imposed if exemption amount exceeded*—(i) *Post–1989 ODCs*. The tax imposed on post–1989 ODCs that a manufacturer or importer sells in qualifying sales for export during a calendar year is equal to the excess (if any) of—

(A) The tax that would be imposed on the ODCs but for section 4682(d)(3) and this section; over

(B) The post–1989 ODC exemption amount for the calendar year determined under paragraph (c)(1) of this section.

(ii) *Post–1990 ODCs*. The tax imposed on post–1990 ODCs that a manufacturer or importer sells in qualifying sales for export during a calendar year is equal to the excess (if any) of—

(A) The tax that would be imposed on the ODCs but for section 4682(d)(3) and this section; over

(B) The post–1990 ODC exemption amount for the calendar year determined under paragraph (c)(2) of this section.

(iii) *Allocation of tax*—(A) *Post–1989 ODCs*. The tax (if any) determined under paragraph (b)(2)(i) of this section may be allocated among the post–1989 ODCs on which it is imposed in any manner, provided that the amount allocated to any post–1989 ODC does not exceed the tax that would be imposed on such ODC but for section 4682(d)(3) and this section.

(B) *Post–1990 ODCs*. The tax (if any) determined under paragraph (b)(2)(ii) of this section may be allocated among the post–1990 ODCs on which it is imposed in any manner, provided that the amount allocated to any post–1990 ODC does not exceed the tax that would be imposed on such ODC but for section 4682(d)(3) and this section.

(c) *Exemption amount*—(1) *Post–1989 ODC exemption amount*. A manufacturer's or importer's post–1989 ODC exemption amount for a calendar year is the sum of the following amounts:

(i) The 1986 export percentage of the aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on the maximum quantity, determined without regard to additional production allowances, of post–1989 ODCs that the person is permitted to manufacture during the calendar year under rules prescribed by the Environmental Protection Agency (40 CFR part 82).

(ii) The aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on post–1989 ODCs that the person manufactures during the calendar year under any additional production allowance granted by the Environmental Protection Agency.

(iii) The aggregate tax that would (but for section 4682(d), section 4682(g),

and this section) be imposed under section 4681 on post–1989 ODCs imported by the person during the calendar year.

(2) *Post–1990 ODC exemption amount.* A manufacturer's or importer's post–1990 ODC exemption amount for a calendar year is the sum of the following amounts:

(i) The 1989 export percentage of the aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on the maximum quantity, determined without regard to additional production allowances, of post–1990 ODCs the person is permitted to manufacture during the calendar year under rules prescribed by the Environmental Protection Agency.

(ii) The aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on post–1990 ODCs that the person manufactures during the calendar year under any additional production allowance granted by the Environmental Protection Agency.

(iii) The aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on post–1990 ODCs imported by the person during the calendar year.

(3) *Definitions*—(i) *1986 export percentage.* See section 4682(d)(3)(B)(ii) for the meaning of the term *1986 export percentage.*

(ii) *1989 export percentage.* See section 4682(d)(3)(C) for the meaning of the term *1989 export percentage.*

(d) *Procedural requirements relating to tax-free sales for export*—(1) *Qualifying sales*—(i) *In general.* A sale of ODCs is a qualifying sale for export if—

(A) The seller is the manufacturer or importer of the ODCs and the purchaser is a purchaser for export or for resale to a second purchaser for export;

(B) At the time of the sale, the seller and the purchaser are registered with the Internal Revenue Service; and

(C) At the time of the sale, the seller—

(*1*) Has an unexpired certificate in substantially the form set forth in paragraph (d)(3)(ii) of this section from the purchaser; and

(*2*) Relies on the certificate in good faith.

(ii) *Qualifying resale.* A sale of ODCs is a qualifying resale for export if—

(A) The seller acquired the ODCs in a qualifying sale for export and the purchaser is a second purchaser for export;

(B) At the time of the sale, the seller and the purchaser are registered with the Internal Revenue Service; and

(C) At the time of the sale, the seller—

(*1*) Has an unexpired certificate in substantially the form set forth in paragraph (d)(3)(ii)(A) of this section from the purchaser of the ODCs; and

(*2*) Relies on the certificate in good faith.

(iii) *Special rule relating to sales made before July 1, 1993.* If a sale for export made before July 1, 1993, satisfies all the requirements of paragraph (d)(1)(i) or (ii) of this section other than those relating to registration, the sale will be treated as a qualifying sale (or resale) for export. Thus, a sale made before July 1, 1993, may be a qualifying sale (or resale) even if the parties to the sale are not registered and the required certificate does not contain statements regarding registration.

(iv) *Registration.* Application for registration is made on Form 637 (or any other form designated for the same use by the Commissioner) according to the instructions applicable to the form. A person is registered only if the district director has issued that person a letter of registration and it has not been revoked or suspended. The effective date of the registration must be no earlier than the date on which the district director signs the letter of registration. Each business unit that has, or is required to have, a separate employer identification number is treated as a separate person.

(2) *Good faith reliance.* The requirements of paragraph (d)(1) of this section are not satisfied with respect to a sale of ODCs and the sale is not a qualifying sale (or resale) if, at the time of the sale—

(i) The seller has reason to believe that the ODCs are not purchased for export; or

(ii) The Internal Revenue Service has notified the seller that the purchaser's registration has been revoked or suspended.

(3) *Certificate*—(i) *In general*. The certificate required under paragraph (d)(1) of this section consists of a statement executed and signed under penalties of perjury by a person with authority to bind the purchaser, in substantially the same form as model certificates provided in paragraph (d)(3)(ii) of this section, and containing all information necessary to complete such model certificate. A new certificate must be given if any information in the current certificate changes. The certificate may be included as part of any business records normally used to document a sale. The certificate expires on the earliest of the following dates—

(A) The date one year after the effective date of the certificate;

(B) The date the purchaser provides a new certificate to the seller; or

(C) The date the seller is notified by the Internal Revenue Service or the purchaser that the purchaser's registration has been revoked or suspended.

(ii) *Model certificates*—(A) *ODCs sold for export by the purchaser*. If the purchaser will export the ODCs, the certificate must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS FOR EXPORT BY THE PURCHASER

(To support tax-free sales under section 4682(d)(3) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

(not more than one year after effective date)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

Purchaser is registered with the Internal Revenue Service as a purchaser of ozone-depleting chemicals for export under registration number _____. Purchaser's registration has not been suspended or revoked by the Internal Revenue Service.

The following percentage of ozone-depleting chemicals purchased from:

_____

(Name of seller)

_____

(Address of seller)

_____

(Taxpayer identifying number of seller)

are purchased for export by Purchaser.

Product	Percentage
CFC–11	_____
CFC–12	_____
CFC–113	_____
CFC–114	_____
CFC–115	_____
Halon-1211	_____
Halon-1301	_____
Halon-2402	_____
Carbon tetrachloride	_____
Methyl chloroform	_____
Other (specify)	
_____	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser understands that Purchaser will be liable for tax imposed under section 4681 if Purchaser does not export the ODCs to which this certificate applies.

Purchaser understands that any use of the ODCs to which this certificate applies other than for export may result in the revocation of Purchaser's registration.

Purchaser will retain the business records needed to document the export of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its registration has been revoked or suspended.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Name of Purchaser

_____

Address of Purchaser

_____

_____

Taxpayer Identifying Number of Purchaser

_____

Title of person signing

_____

Printed or typed name of person signing

_____

Signature

(B) *ODCs sold by the purchaser for resale for export by the second purchaser*. If the purchaser will resell the ODCs to a second purchaser for export by the second purchaser, the certificate must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS FOR RESALE FOR EXPORT BY THE SECOND PURCHASER

(To support tax-free sales under section 4682(d)(3) of the Internal Revenue Code.)

Effective Date _____
Expiration Date _____
(not more than one year after effective date)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

Purchaser is registered with the Internal Revenue Service as a purchaser of ozone-depleting chemicals for export under registration number _____. Purchaser's registration has not been suspended or revoked by the Internal Revenue Service.

The following percentage of ozone-depleting chemicals purchased from:

_____

(Name of seller)

_____

(Address of seller)

_____

(Taxpayer identifying number of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are (1) registered with the Internal Revenue Service as purchasers of ozone-depleting chemicals for export and (2) purchasing the ozone-depleting chemicals for export.

Product	Percentage
CFC–11	_____
CFC–12	_____
CFC–113	_____
CFC–114	_____
CFC–115	_____
Halon-1211	_____
Halon-1301	_____
Halon-2402	_____
Carbon tetrachloride	_____
Methyl chloroform	_____
Other (specify)	
_____	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser understands that Purchaser will be liable for tax imposed under section 4681 if Purchaser does not resell the ODCs to which this certificate applies to a Second Purchaser for export or export those ODCs.

Purchaser understands that any use of the ODCs to which this certificate applies other than for resale to Second Purchasers for export may result in the revocation of Purchaser's registration.

Purchaser will retain the business records needed to document the sales to Second Purchasers for export covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its registration has been revoked or suspended. In addition, the Internal Revenue Service has not notified Purchaser of the revocation or suspension of the registration of any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Name of Purchaser

_____

Address of Purchaser

_____

Taxpayer Identifying Number of Purchaser

_____

Title of person signing

_____

Printed or typed name of person signing

_____

Signature

(4) *Documentation of export*—(i) *After December 31, 1992.* After December 31, 1992, to document the exportation of any ODCs, a person must have the evidence required by the Environmental Protection Agency as proof that the ODCs were exported.

(ii) *Before January 1, 1993.* Before January 1, 1993, to document the exportation of any ODCs, a person must have evidence substantially similar to that required by the Environmental Protection Agency as proof that the ODCs were exported.

(e) *Purchaser liable for tax*—(1) *Purchaser in qualifying sale.* The purchaser of ODCs in a qualifying sale for export is treated as the manufacturer of the ODC and is liable for any tax imposed under section 4681 (determined without regard to exemptions for qualifying sales under this section or § 52.4682–1) when it sells or uses the ODCs if that purchaser does not-

(i) Export the ODCs and document the exportation of the ODCs in accordance with paragraph (d)(4) of this section; or

(ii) Sell the ODCs in a qualifying resale for export.

(2) *Purchaser in qualifying resale.* The purchaser of ODCs in a qualifying resale for export is treated as the manufacturer of the ODC and is liable for any tax imposed under section 4681 (determined without regard to exemptions for qualifying sales under this section or § 52.4682–1) when it sells or uses the ODCs if that purchaser does not export the ODCs and document the exportation of the ODCs in accordance with paragraph (d)(4) of this section.

(f) *Credit or refund*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, a manufacturer or importer that meets the conditions of paragraph (f)(3) of this section is allowed a credit or refund (without interest) of the tax it paid to the government under section 4681 on ODCs that are exported. Persons other than manufacturers and importers of ODCs cannot file claims for credit or refund of tax imposed under section 4681 on ODCs that are exported.

(2) *Limitation.* The amount of credits or refunds of tax under this paragraph (f) is limited—

(i) In the case of tax paid on post-1989 ODCs sold during a calendar year, to the amount (if any) by which the post-1989 exemption amount for the year exceeds the tax benefit provided to such post-1989 ODCs under paragraph (b) of this section; and

(ii) In the case of tax paid on post-1990 ODCs sold during a calendar year, to the amount (if any) by which the post-1990 exemption amount for the year exceeds the tax benefit provided to such post-1990 ODCs under paragraph (b) of this section.

(3) *Conditions to allowance of credit or refund.* The conditions of this paragraph (f)(3) are met if the manufacturer or importer—

(i) Documents the exportation of the ODCs in accordance with paragraph (d)(4) of this section; and

(ii) Establishes that it has—

(A) Repaid or agreed to repay the amount of the tax to the person that exported the ODC; or

(B) Obtained the written consent of the exporter to the allowance of the credit or the making of the refund.

(4) *Procedural rules.* See section 6402 and the regulations under that section for procedural rules relating to filing a claim for credit or refund of tax.

(g) *Examples.* The following examples illustrate the provisions of this section. In each example, the sales are qualifying sales for export (within the meaning of paragraph (d)(1) of this section), all registration, certification, and documentation requirements of this section are met, and the ODCs sold for export are exported:

Example 1. (i) *Facts.* D, a corporation, manufactures CFC–11, a post-1989 ODC, and does not manufacture or import any other ODCs. In 1993, D manufactures 100,000 pounds of CFC–11, the maximum quantity D is allowed to manufacture in 1993 under EPA regulations. D has no additional production allowance from EPA for 1993. In 1993, the tax on CFC–11 is $3.35 per pound. D's 1986 export percentage for post-1989 ODCs is 50%. In 1993, D sells 80,000 pounds of CFC–11 in qualifying sales for export. The remainder of D's production is not exported.

(ii) *Components of limit on tax benefit.* Under paragraph (c)(1) of this section, D's exemption amount for 1993 is equal to the sum of—

(A) D's 1986 export percentage multiplied by the aggregate tax that would (but for section 4682(d), section 4682(g), and § 52.4682–5) be imposed under section 4681 on the maximum

quantity of post-1989 ODCs D is permitted to manufacture during 1993;

(B) The aggregate tax that would (but for section 4682(d), section 4682(g), and § 52.4682–5) be imposed under section 4681 on post-1989 ODCs that D manufactures during 1993 under an additional production allowance; and

(C) The aggregate tax that would (but for section 4682(d), section 4682(g), and § 52.4682–5) be imposed under section 4681 on post-1989 ODCs imported by D during 1993.

(iii) *Limit on tax benefit.* The amounts described in paragraphs (ii)(B) and (C) of this *Example 1* are equal to zero. Thus, D's 1993 exemption amount is $167,500 (50% of $335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC–11 in 1993)).

(iv) *Application of limit on tax benefit.* Under paragraph (b)(2) of this section, the tax imposed on the CFC–11 D sells for export is equal to the excess of the tax that would have been imposed on those ODCs but for section 4682(d) and § 52.4682–5, over D's 1993 exemption amount. But for § 52.4682–5, $268,000 ($3.35 × 80,000) of tax would have been imposed on the CFC–11 sold for export. Thus, $100,500 ($268,000 − $167,500) of tax is imposed on the CFC–11 sold for export.

Example 2. (i) *Facts.* E, a corporation, manufactures CFC–11, a post-1989 ODC, and does not manufacture or import any other ODCs. In 1993, E manufactures 100,000 pounds of CFC–11, the maximum quantity E is allowed to manufacture in 1993 under EPA regulations. E has no additional production allowance from EPA for 1993. In 1993, the tax on CFC–11 is $3.35 per pound. E's 1986 export percentage for post-1989 ODCs is 50%. In 1993, E sells 45,000 pounds of CFC–11 tax free in qualifying sales for export and pays tax under section 4681 on an additional 35,000 pounds of exported CFC–11. The remainder of E's production is not exported.

(ii) *Limit on tax benefit.* E's 1993 exemption amount is $167,500, (50% of $335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC–11 in 1993)). The credit or refund allowed to E under paragraph (f) of this section is limited under paragraph (f)(2) of this section to the amount by which E's 1993 exemption amount exceeds E's 1993 tax benefit under paragraph (b) of this section.

(iii) *Application of limit on tax benefit.* Because E sold 45,000 pounds of CFC–11 tax free in qualifying sales for export in 1993, E's 1993 tax benefit under paragraph (b) of this section is $150,750 ($3.35 × 45,000). Thus, the credit or refund allowed to E under paragraph (f) of this section is limited to $16,750 ($167,500 − $150,750).

Example 3. (i) *Facts.* F, a corporation, manufactures CFC–11, a post-1989 ODC, and does not manufacture any other ODCs. F also imports CFC–11. In 1993, F manufactures 60,000 pounds of CFC–11 (100,000 pounds is the maximum quantity F is allowed to manufacture in 1993 under EPA regulations) and imports 40,000 pounds. F has no additional production allowance from EPA for 1993. In 1993, the tax on CFC–11 is $3.35 per pound. F's 1986 export percentage for post-1989 ODCs is 50%. In 1993, F sells 45,000 pounds of CFC–11 tax free in qualifying sales for export and pays tax under section 4681 on an additional 35,000 pounds of exported CFC–11. The remainder of F's production is not exported.

(ii) *Limit on tax benefit.* F's 1993 exemption amount is $301,500, ($167,500 (50% of $335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC–11 in 1993) plus $134,000 (the tax that would otherwise be imposed on the 40,000 pounds imported)). The credit or refund allowed to F under paragraph (f) of this section is limited under paragraph (f)(2) of this section to the amount by which F's 1993 exemption amount exceeds F's 1993 tax benefit under paragraph (b) of this section.

(iii) *Application of limit on tax benefit.* Because F sold 45,000 pounds of CFC–11 tax free in qualifying sales for export in 1993, F's 1993 tax benefit under paragraph (b) of this section is $150,750 ($3.35 × 45,000). Thus, the credit or refund allowed to F under paragraph (f) of this section is limited to $150,750 ($301,500 − $150,750). The limitation does not affect F's credit or refund because the tax F paid on exported ODCs is only $117,250 ($3.35 × 35,000).

(h) *Effective date.* This section is effective January 1, 1993.

[T.D. 8622, 60 FR 52853, Oct. 11, 1995]

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

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53.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund filed.
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53.6161–1 Extension of time for paying tax or deficiency.
53.6165–1 Bonds where time to pay tax or deficiency has been extended.
53.6601–1 Interest on underpayment, nonpayment, or extensions of time for payment, of tax.
53.6651–1 Failure to file tax return or to pay tax.
53.6694–1 Section 6694 penalties applicable to tax return preparer.
53.6694–2 Penalties for understatement due to an unreasonable position.
53.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.
53.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.
53.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.
53.6696–1 Claims for credit or refund by tax return preparers.
53.7101–1 Form of bonds.
53.7701–1 Tax return preparer.

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Section 53.6060–1 also issued under 26 U.S.C. 6060(a);

Section 53.6081–1 also issued under 26 U.S.C. 6081(a);

Section 53.6109–1 also issued under 26 U.S.C. 6109(a);

Section 53.6109–2 also issued under 26 U.S.C. 6109(a);

Section 53.6695–1 also issued under 26 U.S.C. 6695(b).

Subpart A—Taxes on Investment Income

§ 53.4940–1 Excise tax on net investment income.

(a) *In general.* For taxable years beginning after September 30, 1977, section 4940 imposes an excise tax of 2 percent of the net investment income (as defined in section 4940(c) and paragraph (c) of this section) of a tax-exempt private foundation (as defined in section 509). For taxable years beginning after December 31, 1969, and before October 1, 1977, the tax imposed by section 4940 is 4 percent of the net investment income. This tax will be reported on the form the foundation is required to file under section 6033 for the taxable year and will be paid annually at the time prescribed for filing such annual return (determined without regard to any extension of time for filing). In addition, an excise tax is imposed in the manner prescribed in paragraph (b) of this section on certain non-exempt private foundations (including certain non-exempt charitable trusts). Except as provided in the succeeding sentence, this tax is to be reported by means of a schedule attached to the organization's income tax return. For taxable years ending on or after December 31, 1975, the tax imposed by section 4940(b) and paragraph (b) of this section on a trust described in section 4947(a)(1) which is a private foundation shall be reported on Form 5227. The tax imposed by section 4940(b) and this section is to be paid annually at the time the organization is required to pay its income taxes imposed under subtitle A. Except as otherwise provided herein, no exclusions or deductions from gross investment income or credits against tax are allowable under this section.

(b) *Taxable foundations.* (1) The excise tax imposed under section 4940 on private foundations which are not exempt from taxation under section 501(a) is equal to:

(i) The amount (if any) by which the sum of

(A) The tax on net investment income imposed under section 4940(a), computed as if such private foundation were exempt from taxation under section 501(a) and described in section 501(c)(3) for the taxable year, plus

(B) The amount of the tax which would have been imposed under section 511 for such taxable year if such private foundation had been exempt from taxation under section 501(a), exceeds.

(ii) The tax imposed under subtitle A on such private foundation for the taxable year.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Assume that the tax liability under subtitle A for private foundation X, which is not exempt from taxation under section 501(a) for 1970, is $10,000. Had X been exempt under section 501(a) for 1970, the tax

imposed under section 4940(a) would have been $4,000 and the tax imposed under section 511 would have been $7,000. The excess of the sum of the taxes which would have been imposed under sections 4940(a) and 511 ($11,000) over the tax that was imposed under subtitle A ($10,000) is $1,000, the amount of the tax imposed on such organization under section 4940(b).

Example 2. Assume the facts stated in Example (1), except that the tax liability under subtitle A is $15,000 rather than $10,000. Because the sum of the taxes which would have been imposed under sections 4940(a) and 511 ($11,000) does not exceed the tax that was imposed under subtitle A ($15,000), there is no tax imposed under section 4940(b) with respect to such foundation.

(c) *Net investment income defined*—(1) *In general.* For purposes of section 4940(a), *net investment income* of a private foundation is the amount by which:

(i) The sum of the gross investment income (as defined in section 4940(c)(2) and paragraph (d) of this section) and the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (within the meaning of section 4940(c)(4) and paragraph (f) of this section) exceeds

(ii) The deductions allowed by section 4940(c)(3) and paragraph (e) of this section.

Except to the extent inconsistent with the provisions of this section, net investment income shall be determined under the principles of Subtitle A.

(2) *Tax-exempt income.* For purposes of computing net investment income under section 4940, the provisions of section 103 (relating to interest on certain governmental obligations) and section 265 (relating to expenses and interest relating to tax-exempt income) and the regulations thereunder shall apply.

(d) *Gross investment income*—(1) *In general.* For purposes of paragraph (c) of this section, ''gross investment income'' means the gross amounts of income from interest, dividends, rents, and royalties (including overriding royalties) received by a private foundation from all sources, but does not include such income to the extent included in computing the tax imposed by section 511. Under this definition, interest, dividends, rents, and royalties derived from assets devoted to charitable activities are includible in gross investment income. Therefore, for example, interest received on a student loan would be includible in the gross investment income of a private foundation making such loan. For purposes of paragraph (c) of this section, gross investment income also includes the items of investment income described in § 1.512(b)–1(a).

(2) *Certain estate and trust disbursements.* In the case of a distribution from an estate or a trust described in section 4947(a) (1) or (2), such distribution shall not retain its character in the hands of the distributee for purposes of computing the tax under section 4940; except that, in the case of a distribution from a trust described in section 4947(a)(2), the income of such trust attributable to transfers in trust after May 26, 1969, shall retain its character in the hands of a distributee private foundation for purposes of section 4940 (unless such income is taken into account because of the application of section 671).

(3) *Treatment of certain distributions in redemption of stock.* For purposes of applying section 302(b)(1), any distribution made to a private foundation by a disqualified person (as defined in section 4946(a)), in redemption of stock held by such private foundation in a business enterprise shall be treated as not essentially equivalent to a dividend if all of the following conditions are satisfied: (i) Such redemption is of stock which was owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which is in effect on such date and at all times thereafter, or would have passed under such a will but before that time actually passes under a trust which would have met the test of this subdivision but for the fact that the trust was revocable (but was not in fact revoked)); (ii) such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings); and (iii) such foundation receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the

time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law). In the case of a disposition before January 1, 1975, section 4943 shall be applied without taking section 4943(c) (4) into account. A distribution which otherwise qualifies under section 302 as a distribution in part or full payment in exchange for stock shall not be treated as essentially equivalent to a dividend because it does not meet the requirements of this subparagraph.

(e) *Deductions*—(1) *In general.* (i) For purposes of computing net investment income, there shall be allowed as a deduction from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in subparagraph (2) of this paragraph. Such expenses include that portion of a private foundation's operating expenses which is paid or incurred for the production or collection of gross investment income. Taxes paid or incurred under this section are not paid or incurred for the production or collection of gross investment income. A private foundation's operating expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rent and taxes upon property used in the foundation's operations. Where a private foundation's officers or employees engage in activities on behalf of the foundation for both investment purposes and for exempt purposes, compensation and salaries paid to such officers or employees must be allocated between the investment activities and the exempt activities. To the extent a private foundation's expenses are taken into account in computing the tax imposed by section 511, they shall not be deductible for purposes of computing the tax imposed by section 4940.

(ii) Where only a portion of property produces, or is held for the production of, income subject to the section 4940 excise tax, and the remainder of the property is used for exempt purposes, the deductions allowed by section 4940(c)(3) shall be apportioned between the exempt and non-exempt uses.

(iii) No amount is allowable as a deduction under this section to the extent it is paid or incurred for purposes other than those described in subdivision (i) of this subparagraph. Thus, for example, the deductions prescribed by the following sections are not allowable: (1) The charitable deduction prescribed under section 170 and 642(c); (2) the net operating loss deduction prescribed under section 172; and (3) the special deductions prescribed under Part VIII, Subchapter B, Chapter 1.

(2) *Deduction modifications.* The following modifications shall be made in determining deductions otherwise allowable under this paragraph:

(i) The depreciation deduction shall be allowed, but only on the basis of the straight line method provided in section 167(b)(1).

(ii) The depletion deduction shall be allowed, but such deduction shall be determined without regard to section 613, relating to percentage depletion.

(iii) The basis to be used for purposes of the deduction allowed for depreciation or depletion shall be the basis determined under the rules of Part II of Subchapter O of Chapter 1, subject to the provisions of section 4940(c)(3)(B), and without regard to section 4940(c)(4)(B), relating to the basis for determining gain, or section 362(c). Thus, a private foundation must reduce the cost or other substituted or transferred basis by an amount equal to the straight line depreciation or cost depletion, without regard to whether the foundation deducted such depreciation or depletion during the period prior to its first taxable year beginning after December 31, 1969. However, where a private foundation has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight line or cost method been employed, such excess depreciation or depletion also shall be taken into account to reduce basis. If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to a donee

private foundation, then the original basis to such foundation of such property shall be determined under the rules of § 1.1015–1(a)(3).

(iv) The deduction for expenses paid or incurred in any taxable year for the production of gross investment income earned as an incident to a charitable function shall be no greater than the income earned from such function which is includible as gross investment income for such year. For example, where rental income is incidentally realized in 1971 from historic buildings held open to the public, deductions for amounts paid or incurred in 1971 for the production of such income shall be limited to the amount of rental income includible as gross investment income for 1971.

(f) *Capital gain and losses*—(1) *General rule*. In determining capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for purposes of the tax imposed by section 4940, there shall be taken into account only capital gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program-related investments, as defined in section 4944(c)), and property used for the production of income included in computing the tax imposed by section 511 except to the extent gain or loss from the sale or other disposition of such property is taken into account for purposes of such tax. For taxable years beginning after December 31, 1972, property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interests, mortgages, and securities). Under this subparagraph, gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded. For example, gain or loss on the sale of the buildings used for the exempt activities of a private foundation would not be subject to the section 4940 tax. Where the foundation uses property for its exempt purposes, but also incidentally derives income from such property which is subject to the tax imposed by section 4940(a), any gain or loss resulting from the sale or other disposition of such property is not subject to the tax imposed by section 4940(a). For example, if a tax-exempt private foundation maintains buildings of a historical nature and keeps them open for public inspection, but requires a number of its employees to live in these buildings and charges the employees rent, the rent would be subject to the tax imposed by section 4940(a), but any gain or loss resulting from the sale of such property would not be subject to such tax. However, where the foundation uses property for both exempt purposes and (other than incidentally) for investment purposes (for example, a building in which the foundation's charitable and investment activities are carried on), that portion of any gain or loss from the sale or other disposition of such property which is allocable to the investment use of such property must be taken into account in computing capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such taxable year. For purposes of this paragraph, a distribution of property for purposes described in section 170(c) (1) or (2)(B) which is a qualifying distribution under section 4942 shall not be treated as a sale or other disposition of property.

(2) *Basis*. (i) The basis for purposes of determining gain from the sale or other disposition of property shall be the greater of:

(A) Fair market value on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of disposition under the rules of Part II of Subchapter O of Chapter 1, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to the date of disposition, or

(B) Basis as determined under the rules of Part II of Subchapter O of Chapter 1,

subject to the provisions of section 4940(c)(3)(B) (and without regard to section 362(c)).

(ii) For purposes of determining loss from the sale or other disposition of

property, basis as determined in subdivision (i)(B) of this subparagraph shall apply.

(3) *Losses.* Where the sale or other disposition of property referred to in section 4940(c)(4)(A) results in a capital loss, such loss may be subtracted from capital gains from the sale or other disposition of other such property during the same taxable year, but only to the extent of such gains. Should losses from the sale or other disposition of such property exceed gains from the sale or other disposition of such property during the same taxable year, such excess may not be deducted from gross investment income under section 4940(c)(3) in any taxable year, nor may such excess by used to reduce gains in either prior or future taxable years, regardless of whether the foundation is a corporation or a trust.

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

Example 1. A private foundation holds certain depreciable real property on December 31, 1969, having a basis of $102,000. The fair market value of such property on that date was $100,000. For its taxable year 1970 the foundation was allowed depreciation for such property of $5,100 on the straight line method, the allowable amount computed on the $102,000 basis. The property was sold on January 1, 1971, for $100,000. Because fair market value on December 31, 1969, less straight line depreciation of $5,100 ($94,900) is less than basis as determined by Part II of Subchapter O of Chapter 1, $96,900 ($102,000 less $5,100), a gain of $3,100 is recognized (*i.e.*, sales price of $100,000 less the greater of the two possible bases).

Example 2. Assume the same facts in example 1, except that the sale price was $95,000. Because the sale price was $1,900 less than the basis for loss ($96,900 as determined by the application of subparagraph (2)(ii) of this paragraph), there is a capital loss of $1,900 which may be deducted against capital gains for 1971 (if any) in determining net capital gain (capital gain net income for taxable years beginning after December 31, 1976).

Example 3. A private foundation holds certain depreciable real property on December 31, 1969, having a basis of $102,000. The fair market value of such property on that date was $110,000. For its taxable year 1970 the foundation was allowed depreciation for such property of $5,100 on the straight line method, the allowable amount computed on the $102,000 basis. The property was sold on January 1, 1971, for $100,000. Fair market value on December 31, 1969, less straight line depreciation of $5,100 ($104,900) exceeds basis as determined by Part II of Subchapter O of Chapter 1, $96,900 ($102,000 less $5,100), and will be used for purposes of determining gain. Because basis for purposes of determining gain exceeds sale price, there is no gain. There is no loss because basis for purposes of determining loss ($96,900) is less than sale price.

[T.D. 7250, 38 FR 868, Jan. 5, 1973; 38 FR 7549, Mar. 23, 1973, as amended by T.D. 7407, 41 FR 9321, Mar. 4, 1976; T.D. 7606, 44 FR 18971, Mar. 30, 1979; T.D. 7728, 45 FR 72651, Nov. 3, 1980; T.D. 8423, 57 FR 33444, July 29, 1992]

Subpart B—Taxes on Self-Dealing

SOURCE: T.D. 7270, 38 FR 9493, Apr. 17, 1973, unless otherwise noted.

§ 53.4941(a)–1 Imposition of initial taxes.

(a) *Tax on self-dealer*—(1) *In general.* Section 4941(a)(1) of the code imposes an excise tax on each act of self-dealing between a disqualified person (as defined in section 4946(a)) and a private foundation. Except as provided in subparagraph (2) of this paragraph, this tax shall be imposed on a disqualified person even though he had no knowledge at the time of the act that such act constituted self-dealing. Notwithstanding the preceding two sentences, however, a transaction between a disqualified person and a private foundation will not constitute an act of self-dealing if:

(i) The transaction is a purchase or sale of securities by a private foundation through a stockbroker where normal trading procedures on a stock exchange or recognized over-the-counter market are followed;

(ii) Neither the buyer nor the seller of the securities nor the agent of either knows the identity of the other party involved; and

(iii) The sale is made in the ordinary course of business, and does not involve a block of securities larger than the average daily trading volume of that stock over the previous 4 weeks.

However, the preceding sentence shall not apply to a transaction involving a dealer who is a disqualified person acting as a principal or to a transaction which is an act of self-dealing pursuant to section 4941(d)(1)(B) and § 53.4941(d)–2(c)(1). The tax imposed by section 4941(a)(1) is at the rate of 5 percent of

the amount involved (as defined in section 4941(e)(2) and § 53.4941(e)–1(b)) with respect to the act of self-dealing for each year or partial year in the taxable period (as defined in section 4941(e)(1)) and shall be paid by any disqualified person (other than a foundation manager acting only in the capacity of a foundation manager) who participates in the act of self-dealing. However, if a foundation manager is also acting as a self-dealer, he may be liable for both the tax imposed by section 4941(a)(1) and the tax imposed by section 4941(a)(2).

(2) *Government officials*. In the case of a government official (as defined in sec. 4946(a)), the tax shall be imposed upon such government official who participates in an act of self-dealing, only if he knows that such act is an act of self-dealing. See paragraph (b)(3) of this section for a definition of *knowing*.

(3) *Participation*. For purposes of this paragraph, a disqualified person shall be treated as participating in an act of self-dealing in any case in which he engages or takes part in the transaction by himself or with others, or directs any person to do so.

(b) *Tax on foundation manager*—(1) *In general*. Section 4941(a)(2) of the code imposes an excise tax on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation. This tax is imposed only in cases in which the following circumstances are present:

(i) A tax is imposed by section 4941(a)(1),

(ii) Such participating foundation manager knows that the act is an act of self-dealing, and

(iii) The participation by the foundation manager is willful and is not due to reasonable cause.

The tax imposed by section 4941(a)(2) is at the rate of 2½ percent of the amount involved with respect to the act of self-dealing for each year or partial year in the taxable period and shall be paid by any foundation manager described in subdivisions (ii) and (iii) of this subparagraph.

(2) *Participation*. The term ''participation'' shall include silence or inaction on the part of a foundation manager where he is under a duty to speak or act, as well as any affirmative action by such manager. However, a foundation manager will not be considered to have participated in an act of self-dealing where he has opposed such act in a manner consistent with the fulfillment of his responsibilities to the private foundation.

(3) *Knowing*. For purposes of section 4941, a person shall be considered to have participated in a transaction ''knowing'' that it is an act of self-dealing only if:

(i) He has actual knowledge of sufficient facts so that, based solely upon such facts, such transaction would be an act of self-dealing,

(ii) He is aware that such an act under these circumstances may violate the provisions of Federal tax law governing self-dealing, and

(iii) He negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or he is in fact aware that it is such an act.

For purposes of this part and Chapter 42, the term ''knowing'' does not mean ''having reason to know''. However, evidence tending to show that a person has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of such fact or rule. Thus, for example, evidence tending to show that a person has reason to know of sufficient facts so that, based solely upon such facts, a transaction would be an act of self-dealing is relevant in determining whether he has actual knowledge of such facts.

(4) *Willful*. Participation by a foundation manager shall be deemed willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by a foundation manager is not willful if he does not know that the transaction in which he is participating is an act of self-dealing.

(5) *Due to reasonable cause*. A foundation manager's participation is due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

(6) *Advice of counsel.* If a person, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that an act is not an act of self-dealing under section 4941, although such act is subsequently held to be an act of self-dealing, the person's participation in such act will ordinarily not be considered ''knowing'' or ''willful'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4941(a)(2). For purposes of this subparagraph, a written legal opinion will be considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an act shall not, by itself, give rise to any inference that a person participated in such act knowingly, willfully, or without reasonable cause.

(c) *Burden of proof.* For provisions relating to the burden of proof in cases involving the issue whether a foundation manager or a government official has knowingly participated in an act of self-dealing, see section 7454(b).

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7299, 38 FR 35304, Dec. 27, 1973]

§ 53.4941(b)–1 Imposition of additional taxes.

(a) *Tax on self-dealer.* Section 4941(b)(1) of the Code imposes an excise tax in any case in which an initial tax is imposed by section 4941(a)(1) on an act of self-dealing by a disqualified person with a private foundation and the act is not corrected within the taxable period (as defined in § 53.4941(e)–1(a)). The tax imposed by section 4941(b)(1) is at the rate of 200 percent of the amount involved and shall be paid by any disqualified person (other than a foundation manager action only in the capacity of a foundation manager) who participated in the act of self-dealing.

(b) *Tax on foundation manager.* Section 4941(b)(2) of the Code imposes an excise tax to be paid by a foundation manager in any case in which a tax is imposed by section 4941(b)(1) and the foundation manager refused to agree to part or all of the correction of the self-dealing act. The tax imposed by section 4941(b)(2) is at the rate of 50 percent of the amount involved and shall be paid by any foundation manager who refused to agree to part or all of the correction of the self-dealing act. For the limitations on liability of a foundation manager, see § 53.4941(c)–1(b).

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 8084, 51 FR 16301, May 2, 1986]

§ 53.4941(c)–1 Special rules.

(a) *Joint and several liability.* (1) In any case where more than one person is liable for the tax imposed by any paragraph of section 4941 (a) or (b), all such persons shall be jointly and severally liable for the taxes imposed under such paragraph with respect to such act of self-dealing.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. A and B, who are managers of private foundation X, lend one of the foundation's paintings to G, a disqualified person, for display in G's office, in a transaction which gives rise to liability for tax under section 4941(a)(2) (relating to tax on foundation managers). An initial tax is imposed on both A and B with respect to the act of lending the foundation's painting to G. A and B are jointly and severally liable for the tax.

(b) *Limits on liability for management.* (1) The maximum aggregate amount of tax collectible under section 4941(a)(2) from all foundation managers with respect to any one act of self-dealing shall be $10,000, and the maximum aggregate amount of tax collectible under section 4941(b)(2) from all foundation managers with respect to any one act of self-dealing shall be $10,000.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. A, a disqualified person with respect to private foundation Y, sells certain real estate having a fair market value of $500,000 to Y for $500,000 in cash. B, C, and D, all the managers of foundation Y, authorized the purchase on Y's behalf knowing that such purchase was an act of self-dealing. The actions of B, C, and D in approving the purchase were willful and not due to reasonable

cause. Initial taxes are imposed upon the foundation managers under subsections (a)(2) and (c)(2) of section 4941. The tax to be paid by the foundation managers is $10,000 (the lesser of $10,000 or 2½ percent of the amount involved). The managers are jointly and severally liable for this $10,000, and this sum may be collected by the Internal Revenue Service from any one of them.

§ 53.4941(d)–1 Definition of self-dealing.

(a) *In general*. For purposes of section 4941, the term *self-dealing* means any direct or indirect transaction described in § 53.4941(d)–2. For purposes of this section, it is immaterial whether the transaction results in a benefit or a detriment to the private foundation. The term ''self-dealing'' does not, however, include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of such transaction. For example, the bargain sale of property to a private foundation is not a direct act of self-dealing if the seller becomes a disqualified person only by reason of his becoming a substantial contributor as a result of the bargain element of the sale. For the effect of sections 4942, 4943, 4944, and 4945 upon an act of self-dealing which also results in the imposition of tax under one or more of such sections, see the regulations under those sections.

(b) *Indirect self-dealing*—(1) *Certain business transactions*. The term ''indirect self-dealing'' shall not include any transaction described in § 53.4941(d)–2 between a disqualified person and an organization controlled by a private foundation (within the meaning of paragraph (6)(5) of this section) if:

(i) The transaction results from a business relationship which was established before such transaction constituted an act of self-dealing (without regard to this paragraph),

(ii) The transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and

(iii) Either:

(*a*) The organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization, or

(*b*) Because of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship. See example (2) of subparagraph (8) of this paragraph.

(2) *Grants to intermediaries*. The term ''indirect self-dealing'' shall not include a transaction engaged in with a government official by an intermediary organization which is a recipient of a grant from a private foundation and which is not controlled by such foundation (within the meaning of paragraph (6) (5) of this section) if the private foundation does not earmark the use of the grant for any named government official and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the selection of the government official by the intermediary organization. A grant by a private foundation is earmarked if such grant is made pursuant to an agreement, either oral or written, that the grant will be used by any named individual. Thus, a grant by a private foundation shall not constitute an indirect act of self-dealing even though such foundation had reason to believe that certain government officials would derive benefits from such grant so long as the intermediary organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation. See example (3) of subparagraph (8) of this paragraph.

(3) *Transactions during the administration of an estate or revocable trust*. The term ''indirect self-dealing'' shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if:

(i) The administrator or executor of an estate or trustee of a revocable trust either:

(*a*) Possesses a power of sale with respect to the property,

(*b*) Has the power to reallocate the property to another beneficiary, or

(*c*) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of §1.641(b)–3 of this chapter (or in the case of a revocable trust, before it is considered subject to sec. 4947);

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either:

(*a*) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(*b*) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

(*c*) Is required under the terms of any option which is binding on the estate (or trust).

(4) *Transactions with certain organizations.* A transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of subparagraph (5) of this paragraph), and which is not described in section 4946(a)(1) (E), (F), or (G) because persons described in section 4946(a)(1) (A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

(5) *Control.* For purposes of this paragraph, an organization is controlled by a private foundation if the foundation or one or more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing. Similarly, for purposes of this paragraph, an organization is controlled by a private foundation in the case of such a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of section 4946(a)(1) (C) through (G)) to such disqualified person, may, only by aggregating their votes or positions of authority with that of the foundation, require the organization to engage in such a transaction. The ''controlled'' organization need not be a private foundation; for example, it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization. For purposes of this paragraph, an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons referred to in the second sentence of this subparagraph if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing. A private foundation shall not be regarded as having control over an organization merely because it exercises expenditure responsibility (as defined in section 4945 (d)(4) and (h)) with respect to contributions to such organization. See example (6) of subparagraph (8) of this paragraph.

(6) *Certain transactions involving limited amounts.* The term ''indirect self-dealing'' shall not include any transaction between a disqualified person and an organization controlled by a private foundation (within the meaning of subparagraph (5) of this paragraph) or between two disqualified persons

where the foundation's assets may be affected by the transaction if:

(i) The transaction arises in the normal and customary course of a retail business engaged in with the general public,

(ii) In the case of a transaction between a disqualified person and an organization controlled by a private foundation, the transaction is at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and

(iii) The total of the amounts involved in such transactions with respect to any one such disqualified person in any one taxable year does not exceed $5,000.

See example (7) of subparagraph (8) of this paragraph.

(7) *Applicability of statutory exceptions to indirect self-dealing*. The term ''indirect self-dealing'' shall not include a transaction involving one or more disqualified persons to which a private foundation is not a party, in any case in which the private foundation, by reason of section 4941(d)(2), could itself engage in such a transaction. Thus, for example, even if a private foundation has control (within the meaning of subparagraph (5) of this paragraph) of a corporation, the corporation may pay to a disqualified person, except a government official, reasonable compensation for personal services.

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

Example 1. Private foundation P owns the controlling interest of the voting stock of corporation X, and as a result of such interest, elects a majority of the board of directors of X. Two of the foundation managers, A and B, who are also directors of corporation X, form corporation Y for the purpose of building and managing a country club. A and B receive a total of 40 percent of Y's stock, making Y a disqualified person with respect to P under section 4946(a)(1)(E). In order to finance the construction and operation of the country club, Y requested and received a loan in the amount of $4 million from X. The making of the loan by X to Y shall constitute an indirect act of self-dealing between P and Y.

Example 2. Private foundation W owns the controlling interest of the voting stock of corporation X, a manufacturer of certain electronic computers. Corporation Y, a disqualified person with respect to W, owns the patent for, and manufactures, one of the essential component parts used in the computers. X has been making regular purchases of the patented component from Y since 1965, subject to the same terms as all other purchasers of such component parts. X could not buy similar components from another source. Consequently, X would suffer severe economic hardship if it could not continue to purchase these components from Y, since it would then be forced to develop a computer which could be constructed with other components. Under these circumstances, the continued purchase by X from Y of these components shall not be an indirect act of self-dealing between W and Y.

Example 3. Private foundation Y made a grant to M University, an organization described in section 170(b)(1)(A)(ii), for the purpose of conducting a seminar to study methods for improving the administration of the judicial system. M is not controlled by Y within the meaning of subparagraph (5) of this paragraph. In conducting the seminar, M made payments to certain government officials. By the nature of the grant, Y had reason to believe that government officials would be compensated for participation in the seminar. M, however, had completely independent control over the selection of such participants. Thus, such grant by Y shall not constitute an indirect act of self-dealing with respect to the government officials.

Example 4. A, a substantial contributor to P, a private foundation, bequeathed one-half of his estate to his spouse and one-half of his estate to P. Included in A's estate is a one-third interest in AB, a partnership. The other two-thirds interest in AB is owned by B, a disqualified person with respect to P. The one-third interest in AB was subject to an option agreement when it was acquired by the estate. The executor of A's estate sells the one-third interest in AB to B pursuant to such option agreement at the price fixed in such option agreement in a sale which meets the requirements of subparagraph (3) of this paragraph. Under these circumstances, the sale does not constitute an indirect act of self-dealing between B and P.

Example 5. A bequeathed $100,000 to his wife and a piece of unimproved real estate of equivalent value to private foundation Z, of which A was the creator and a foundation manager. Under the laws of State Y, to which the estate is subject, title to the real estate vests in the foundation upon A's death. However, the executor has the power under State law to reallocate the property to another beneficiary. During a reasonable period for administration of the estate, the executor exercises this power and distributes the $100,000 cash to the foundation and the real estate to A's wife. The probate court having jurisdiction over the estate approves

the executor's action. Under these circumstances, the executor's action does not constitute an indirect act of self-dealing between the foundation and A's wife.

Example 6. Private foundation P owns 20 percent of the voting stock of corporation W. A, a substantial contributor with respect to P, owns 16 percent of the voting stock of corporation W. B, A's son, owns 15 percent of the voting stock of corporation W. The terms of the voting stock are such that P, A, and B could vote their stock in a block to elect a majority of the board of directors of W. W is treated as controlled by P (within the meaning of subparagraph (5) of this paragraph) for purposes of this example A and B also own 50 percent of the stock of corporation Y, making Y a disqualified person with respect to P under section 4946(a)(1)(E). W makes a loan to Y of $1 million. The making of this loan by W to Y shall constitute an indirect act of self-dealing between P and Y.

Example 7. A, a disqualified person with respect to private foundation P, enters into a contract with corporation M, which is also a disqualified person with respect to P. P owns 20 percent of M's stock, and controls M within the meaning of subparagraph (5) of this paragraph. M is in the retail department store business. Purchases by A of goods sold by M in the normal and customary course of business at retail or higher prices are not indirect acts of self-dealing so long as the total of the amounts involved in all of such purchases by A in any one year does not exceed $5,000.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended at 38 FR 12604, May 14, 1973]

§ 53.4941(d)–2 Specific acts of self-dealing.

Except as provided in § 53.4941(d)–3 or § 53.4941(d)–4:

(a) *Sale or exchange of property*—(1) *In general.* The sale or exchange of property between a private foundation and a disqualified person shall constitute an act of self-dealing. For example, the sale of incidental supplies by a disqualified person to a private foundation shall be an act of self-dealing regardless of the amount paid to the disqualified person for the incidental supplies. Similarly, the sale of stock or other securities by a disqualified person to a private foundation in a ''bargain sale'' shall be an act of self-dealing regardless of the amount paid for such stock or other securities. An installment sale may be subject to the provisions of both section 4941(d)(1)(A) and section 4941(d)(1)(B).

(2) *Mortgaged property.* For purposes of subparagraph (1) of this paragraph, the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the foundation assumes a mortgage or similar lien which was placed on the property prior to the transfer, or takes subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of transfer. For purposes of this subparagraph, the term ''similar lien'' shall include, but is not limited to, deeds of trust and vendors' liens, but shall not include any other lien if such lien is insignificant in relation to the fair market value of the property transferred.

(b) *Leases*—(1) *In general.* Except as provided in subparagraphs (2) and (3) of this paragraph, the leasing of property between a disqualified person and a private foundation shall constitute an act of self-dealing.

(2) *Certain leases without charge.* The leasing of property by a disqualified person to a private foundation shall not be an act of self-dealing if the lease is without charge. For purposes of this subparagraph, a lease shall be considered to be without charge even though the private foundation pays for janitorial services, utilities, or other maintenance costs it incurs for the use of the property, so long as the payment is not made directly or indirectly to a disqualified person.

(3) *Certain leases of office space.* For taxable years beginning after December 31, 1979, the leasing of office space by a disqualified person to a private foundation shall not be an act of self-dealing if:

(i) The leased space is in a building in which there are other tenants who are not disqualified persons,

(ii) The lease is pursuant to a binding lease which was in effect on October 9, 1969, or pursuant to renewals of such a lease,

(iii) The execution of the lease was not a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law) at the time of such execution, and

(iv) The terms of the lease (or any renewal) reflect an arm's length transaction.

A lease or renewal of such lease is described in this subparagraph (3) only if it satisfies the requirements of § 53.4941(d)–4(c) (1) and (2), applied without regard to the December 31, 1979 deadline described therein.

(c) *Loans*—(1) *In general.* Except as provided in subparagraphs (2), (3), and (4) of this paragraph, the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act of self-dealing. Thus, for example, an act of self-dealing occurs where a third party purchases property and assumes a mortgage, the mortgagee of which is a private foundation, and subsequently the third party transfers the property to a disqualified person who either assumes liability under the mortgage or takes the property subject to the mortgage. Similarly, except in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)–1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.

(2) *Loans without interest.* Subparagraph (1) of this paragraph shall not apply to the lending of money or other extension of credit by a disqualified person to a private foundation if the loan or other extension of credit is without interest or other charge.

(3) *Certain evidences of future gifts.* The making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit (within the meaning of this paragraph) before the date of maturity.

(4) *General banking functions.* Under section 4941(d)(2)(E) the performance by a bank or trust company which is a disqualified person of trust functions and certain general banking services for a private foundation is not an act of self-dealing, where the banking services are reasonable and necessary to carrying out the exempt purposes of the private foundation, if the compensation paid to the bank or trust company, taking into account the fair interest rate for the use of the funds by the bank or trust company, for such services is not excessive. The general banking services allowed by this subparagraph are:

(i) Checking accounts, as long as the bank does not charge interest on any overwithdrawals,

(ii) Savings accounts, as long as the foundation may withdraw its funds on no more than 30-days notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit, and

(iii) Safekeeping activities.

See example (3) § 53.4941(d)–3(c)(2).

(d) *Furnishing goods, services, or facilities*—(1) *In general.* Except as provided in subparagraph (2) or (3) of this paragraph (or § 53.4941(d)–3(b)), the furnishing of goods, services, or facilities between a private foundation and a disqualified person shall constitute an act of self-dealing. This subparagraph shall apply, for example, to the furnishing of goods, services, or facilities such as office space, automobiles, auditoriums, secretarial help, meals, libraries, publications, laboratories, or parking lots. Thus, for example, if a foundation furnishes personal living quarters to a disqualified person (other than a foundation manager or employee) without charge, such furnishing shall be an act of self-dealing.

(2) *Furnishing of goods, services, or facilities to foundation managers and employees.* The furnishing of goods, services, or facilities such as those described in subparagraph (1) of this paragraph to a foundation manager in recognition of his services as a foundation manager, or to another employee (including an individual who would be an employee but for the fact that he receives no compensation for his services) in recognition of his services in such capacity, is not an act of self-dealing if the value of such furnishing (whether or not includible as compensation in his gross income) is reasonable and necessary to the performance of his tasks in carrying out the exempt purposes of the foundation and,

taken in conjunction with any other payment of compensation or payment or reimbursement of expenses to him by the foundation, is not excessive. For example, if a foundation furnishes meals and lodging which are reasonable and necessary (but not excessive) to a foundation manager by reason of his being a foundation manager, then, without regard to whether such meals and lodging are excludable from gross income under section 119 as furnished for the convenience of the employer, such furnishing is not an act of self-dealing. For the effect of section 4945(d)(5) upon an expenditure for unreasonable administrative expenses, see §53.4945–6(b)(2).

(3) *Furnishing of goods, services, or facilities by a disqualified person without charge.* The furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if they are furnished without charge. Thus, for example, the furnishing of goods such as pencils, stationery, or other incidental supplies, or the furnishing of facilities such as a building, by a disqualified person to a foundation shall be allowed if such supplies or facilities are furnished without charge. Similarly, the furnishing of services (even though such services are not personal in nature) shall be permitted if such furnishing is without charge. For purposes of this subparagraph, a furnishing of goods shall be considered without charge even though the private foundation pays for transportation, insurance, or maintenance costs it incurs in obtaining or using the property, so long as the payment is not made directly or indirectly to the disqualified person.

(e) *Payment of compensation.* The payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person shall constitute an act of self-dealing. See, however, §53.4941(d)–3(c) for the exception for the payment of compensation by a foundation to a disqualified person for personal services which are reasonable and necessary to carry out the exempt purposes of the foundation.

(f) *Transfer or use of the income or assets of a private foundation*—(1) *In general.* The transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation shall constitute an act of self-dealing. For purposes of the preceding sentence, the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person. Similarly, the indemnification (of a lender) or guarantee (of repayment) by a private foundation with respect to a loan to a disqualified person shall be treated as a use for the benefit of a disqualified person of the income or assets of the foundation (within the meaning of this subparagraph). In addition, if a private foundation makes a grant or other payment which satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing to which this subparagraph applies. However, if a private foundation makes a grant or payment which satisfies a pledge, enforceable under local law, to an organization described in section 501(c)(3), which pledge is made on or before April 16, 1973, such grant or payment shall not constitute an act of self-dealing to which this subparagraph applies so long as the disqualified person obtains no substantial benefit, other than the satisfaction of his obligation, from such grant or payment.

(2) *Certain incidental benefits.* The fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. Thus, the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous. For example, a grant by a private foundation to a section 509(a) (1), (2), or (3) organization will not be an act of self-dealing merely because such organization is located in the same area as a corporation which is a substantial contributor to the foundation, or merely because one

of the section 509(a) (1), (2), or (3) organization's officers, directors, or trustees is also a manager of or a substantial contributor to the foundation. Similarly, a scholarship or a fellowship grant to a person other than a disqualified person, which is paid or incurred by a private foundation in accordance with a program which is consistent with:

(i) The requirements of the foundation's exempt status under section 501(c)(3),

(ii) The requirements for the allowance of deductions under section 170 for contributions made to the foundation, and

(iii) The requirements of section 4945(g)(1),

will not be an act of self-dealing under section 4941(d)(1) merely because a disqualified person indirectly receives an incidental benefit from such grant. Thus, a scholarship or a fellowship grant made by a private foundation in accordance with a program to award scholarships or fellowship grants to the children of employees of a substantial contributor shall not constitute an act of self-dealing if the requirements of the preceding sentence are satisfied. For an example of the kind of scholarship program with an employment nexus that meets the above requirements, see § 53.4945–4(b)(5) (example 1).

(3) *Non-compensatory indemnification of foundation managers against liability for defense in civil proceedings.* (i) Except as provided in § 53.4941(d)–3(c), section 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to the manager's defense in any civil judicial or civil administrative proceeding arising out of the manager's performance of services (or failure to perform services) on behalf of the foundation, against all expenses (other than taxes, including taxes imposed by chapter 42, penalties, or expenses of correction) including attorneys' fees, judgments and settlement expenditures if—

(A) Such expenses are reasonably incurred by the manager in connection with such proceeding; and

(B) The manager has not acted willfully and without reasonable cause with respect to the act or failure to act which led to such proceeding or to liability for tax under chapter 42.

(ii) Similarly, except as provided in § 53.4941(d)–3(c), section 4941(d)(1) shall not apply to premiums for insurance to make or to reimburse a foundation for an indemnification payment allowed pursuant to this paragraph (f)(3). Neither shall an indemnification or payment of insurance allowed pursuant to this paragraph (f)(3) be treated as part of the compensation paid to such manager for purposes of determining whether the compensation is reasonable under chapter 42.

(4) *Compensatory indemnification of foundation managers against liability for defense in civil proceedings.* (i) The indemnification by a private foundation of a foundation manager for compensatory expenses shall be an act of self-dealing under this paragraph unless when such payment is added to other compensation paid to such manager the total compensation is reasonable under chapter 42. A compensatory expense for purposes of this paragraph (f) is—

(A) Any penalty, tax (including a tax imposed by chapter 42), or expense of correction that is owed by the foundation manager;

(B) Any expense not reasonably incurred by the manager in connection with a civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation; or

(C) Any expense resulting from an act or failure to act with respect to which the manager has acted willfully and without reasonable cause.

(ii) Similarly, the payment by a private foundation of the premiums for an insurance policy providing liability insurance to a foundation manager for expenses described in this paragraph (f)(4) shall be an act of self-dealing under this paragraph (f) unless when such premiums are added to other compensation paid to such manager the total compensation is reasonable under chapter 42.

(5) *Insurance allocation.* A private foundation shall not be engaged in an act of self-dealing if the foundation purchases a single insurance policy to provide its managers both the non-compensatory and the compensatory

coverage discussed in this paragraph (f), provided that the total insurance premium is allocated and that each manager's portion of the premium attributable to the compensatory coverage is included in that manager's compensation for purposes of determining reasonable compensation under chapter 42.

(6) *Indemnification*. For purposes of this paragraph (f), the term *indemnification* shall include not only reimbursement by the foundation for expenses that the foundation manager has already incurred or anticipates incurring but also direct payment by the foundation of such expenses as the expenses arise.

(7) *Taxable income*. The determination of whether any amount of indemnification or insurance premium discussed in this paragraph (f) is included in the manager's gross income for individual income tax purposes is made on the basis of the provisions of chapter 1 and without regard to the treatment of such amount for purposes of determining whether the manager's compensation is reasonable under chapter 42.

(8) *De minimis items*. Any property or service that is excluded from income under section 132(a)(4) may be disregarded for purposes of determining whether the recipient's compensation is reasonable under chapter 42.

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

Example 1. M, a private foundation, makes a grant of $50,000 to the governing body of N City for the purpose of alleviating the slum conditions which exist in a particular neighborhood of N. Corporation P, a substantial contributor to M, is located in the same area in which the grant is to be used. Although the general improvement of the area may constitute an incidental and tenuous benefit to P, such benefit by itself will not constitute an act of self-dealing.

Example 2. Private foundation X established a program to award scholarship grants to the children of employees of corporation M, a substantial contributor to X. After disclosure of the method of carrying out such program, X received a determination letter from the Internal Revenue Service stating that X is exempt from taxation under section 501(c)(3), that contributions to X are deductible under section 170, and that X's scholarship program qualifies under section 4945(g)(1). A scholarship grant to a person not a disqualified person with respect to X paid or incurred by X in accordance with such program shall not be an indirect act of self-dealing between X and M.

Example 3. Private foundation Y owns voting stock in corporation Z, the management of which includes certain disqualified persons with respect to Y. Prior to Z's annual stockholder meeting, the management solicits and receives the foundation's proxies. The transfer of such proxies in and of itself shall not be an act of self-dealing.

Example 4. A, a disqualified person with respect to private foundation S, contributes certain real estate to S for the purpose of building a neighborhood recreation center in a particular underprivileged area. As a condition of the gift, S agrees to name the recreation center after A. Since the benefit to A is only incidental and tenuous, the naming of the recreation center, by itself, will not be an act of self-dealing.

(g) *Payment to a government official*. Except as provided in section 4941(d)(2)(G) or § 53.4941(d)–3(e), the agreement by a private foundation to make any payment of money or other property to a government official, as defined in section 4946(c), shall constitute an act of self-dealing. For purposes of this paragraph, an individual who is otherwise described in section 4946(c) shall be treated as a government official while on leave of absence from the government without pay.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7938, 49 FR 3848, Jan. 31, 1984; T.D. 8639, 60 FR 65568, Dec. 20, 1995]

§ 53.4941(d)–3 Exceptions to self-dealing.

(a) *General rule*. In general, a transaction described in section 4941(d)(2)(B), (C), (D), (E), (F), (G), or (H) is not an act of self-dealing. Section 4941(d)(2)(B), (C), and (H) provide limited exceptions to certain specific transactions, as described in paragraphs (b)(2), (b)(3), (c)(2), and (d)(3) of § 53.4941(d)–2. Section 4941(d)(2) (D), (E), (F), and (G) and paragraphs (b) through (e) of this section described certain transactions which are not acts of self-dealing.

(b) *Furnishing of goods, services, or facilities to a disqualified person*—(1) *In general*. Under section 4941(d)(2)(D), the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such goods, services, or

facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person. This subparagraph shall not apply, however, in the case of goods, services, or facilities furnished later than May 16, 1973, unless such goods, services, or facilities are functionally related, within the meaning of section 4942(j)(5), to the exercise or performance by a private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(c)(3).

(2) *General public.* For purposes of this paragraph, the term ''general public'' shall include those persons who, because of the particular nature of the activities of the private foundation, would be reasonably expected to utilize such goods, services, or facilities. This paragraph shall not apply, however, unless there is a substantial number of persons other than disqualified persons who are actually utilizing such goods, services, or facilities. Thus, a private foundation which furnishes recreational or park facilities to the general public may furnish such facilities to a disqualified person provided they are furnished to him on a basis which is not more favorable than that on which they are furnished to the general public. Similarly, the sale of a book or magazine by a private foundation to disqualified persons shall not be an act of self-dealing if the publication of such book or magazine is functionally related to a charitable or educational activity of the foundation and the book or magazine is made available to the disqualified persons and the general public at the same price. In addition, if the terms of the sale require, for example, payment within 60 days from the date of delivery of the book or magazine, such terms are consistent with normal commercial practices, and payment is made within the 60-day period, the transaction shall not be treated as a loan or other extension of credit under § 53.4941(d)–2(c)(1).

(c) *Payment of compensation for certain personal services*—(1) *In general.* Under section 4941(d)(2)(E), except in the case of a Government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses, including reasonable advances for expenses anticipated in the immediate future) by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of self-dealing if such compensation (or payment or reimbursement) is not excessive. For purposes of this subparagraph the term ''personal services'' includes the services of a broker serving as agent for the private foundation, but not the services of a dealer who buys from the private foundation as principal and resells to third parties. For the determination whether compensation is excessive, see § 1.162–7 of this chapter (Income Tax Regulations). This paragraph applies without regard to whether the person who receives the compensation (or payment or reimbursement) is an individual. The portion of any payment which represents payment for property shall not be treated as payment of compensation (or payment or reimbursement of expenses) for the performance of personal services for purposes of this paragraph. For rules with respect to the performance of general banking services, see § 53.4941(d)–2(c)(4). Further, the making of a cash advance to a foundation manager or employee for expenses on behalf of the foundation is not an act of self-dealing, so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager. Except where reasonably allowable pursuant to subdivision (iii) of this subparagraph, such advances shall not ordinarily exceed $500. For example, if a foundation makes an advance to a foundation manager to cover anticipated out-of-pocket current expenses for a reasonable period (such as a month) and the manager accounts to the foundation under a periodic reimbursement program for actual expenses incurred, the foundation will not be regarded as having engaged in an act of self-dealing:

(i) When it makes the advance,

(ii) When it replenishes the funds upon receipt of supporting vouchers from the foundation manager, or

(iii) If it temporarily adds to the advance to cover extraordinary expenses

anticipated to be incurred in fulfillment of a special assignment (such as long distance travel).

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

Example 1. M, a partnership, is a firm of 10 lawyers engaged in the practice of law. A and B, partners in M, serve as trustees to private foundation W and, therefore, are disqualified persons. In addition, A and B own more than 35 percent of the profits interest in M, thereby making M a disqualified person. M performs various legal services for W from time to time as such services are requested. The payment of compensation by W to M shall not constitute an act of self-dealing if the services performed are reasonable and necessary for the carrying out of W's exempt purposes and the amount paid by W for such services is not excessive.

Example 2. C, a manager of private foundation X, owns an investment counseling business. Acting in his capacity as an investment counselor, C manages X's investment portfolio for which he receives an amount which is determined to be not excessive. The payment of such compensation to C shall not constitute an act of self-dealing.

Example 3. M, a commercial bank, serves as a trustee for private foundation Y. In addition to M's duties as trustee, M maintains Y's checking and savings accounts and rents a safety deposit box to Y. The use of the funds by M and the payment of compensation by Y to M for such general banking services shall be treated as the payment of compensation for the performance of personal services which are reasonable and necessary to carry out the exempt purposes of Y if such compensation is not excessive.

Example 4. D, a substantial contributor to private foundation Z, owns a factory which manufactures microscopes. D contracts with Z to manufacture 100 microscopes for Z. Any payment to D under the contract shall constitute an act of self-dealing, since such payment does not constitute the payment of compensation for the performance of personal services.

(d) *Certain transactions between a foundation and a corporation*—(1) *In general.* Under section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person will not be an act of self-dealing if such transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, so long as all the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. For purposes of this paragraph, all of the securities are not ''subject to the same terms unless, pursuant to such transaction,'' The corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities. The fact that a private foundation receives property, such as debentures, while all other persons holding securities of the same class receive cash for their interests, will be evidence that such offer was not made on a uniform basis. This paragraph may apply even if no other person holds any securities of the class held by the foundation. In such event, however, the consideration received by holders of other classes of securities, or the interests retained by holders of such other classes, when considered in relation to the consideration received by the foundation, must indicate that the foundation received at least as favorable treatment in relation to its interests as the holders of any other class of securities. In addition, the foundation must receive no less than the fair market value of its interests.

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

Example 1. Private foundation X owns 50 percent of the class A preferred stock of corporation M, which is a disqualified person with respect to X. The terms of such securities provide that the stock may be called for redemption at any time by M at 105 percent of the face amount of the stock. M exercises this right and calls all the class A preferred stock by paying 105 percent of the face amount in cash. At the time of the redemption of the class A preferred stock, it is determined that the fair market value of the preferred stock is equal to its face amount. In such case, the redemption by M of the preferred stock of X is not an act of self-dealing.

Example 2. Private foundation Y, which is on a calendar year basis, acquires 60 percent of the class A preferred stock of corporation N by will on January 10, 1970. N, which is also on a calendar year basis, is a disqualified person with respect to Y. In 1971, N offers to redeem all of the class A preferred stock for a consideration equal to 100 percent of the face amount of such stock by the issuance of debentures. The offer expires January 2, 1972. Both Y and all other holders of the class A preferred stock accept the

offer and enter into the transaction on January 2, 1972, at which time it is determined that the fair market value of the debentures is no less than the fair market value of the preferred stock. The transaction on January 2, 1972, shall not be treated as an act of self-dealing for 1972. However, because under § 53.4941 (e)–1 (e)(1)(i) an act of self dealing occurs on the first day of each taxable year or portion of a taxable year that an extension of credit from a foundation to a disqualified person goes uncorrected, if such debentures are held by Y after December 31, 1972, except as provided in § 53.4941(d)–4(c)(4), such extension of credit shall not be excepted from the definition of an act of self dealing by reason of the January 2, 1972, transaction. See § 53.4941(d)–4(c)(4) for rules indicating that under certain circumstances such debentures could be held by Y until December 31, 1979.

(e) *Certain payments to government officials*. Under section 4941(d)(2)(G), in the case of a government official, in addition to the exceptions provided in section 4941(d)(2) (B), (C), and (D), section 4941(d)(1) shall not apply to:

(1) A prize or award which is not includible in gross income under section 74(b), if the government official receiving such prize or award is selected from the general public;

(2) A scholarship or a fellowship grant which is excludable from gross income under section 117(a) and which is to be utilized for study at an educational institution described in section 151(e)(4);

(3) Any annuity or other payment (forming part of a stock-bonus, pension, or profit sharing plan) by a trust which constitutes a qualified trust under section 401;

(4) Any annuity or other payment under a plan which meets the requirements of section 404(a)(2);

(5) Any contribution or gift (other than a contribution or gift of money) to, or services or facilities made available to, any government official, if the aggregate value of such contributions, gifts, services, and facilities does not exceed $25 during any calendar year;

(6) Any payment made under 5 U.S.C. Chapter 41 (relating to government employees' training programs);

(7) Any payment or reimbursement of traveling expenses (including amounts expended for meals and lodging, regardless of whether the government official is away from home within the meaning of section 162(a)(2), and including reasonable advances for such expenses anticipated in the immediate future) for travel solely from one point in the United States to another in connection with one or more purposes described in section 170(c) (1) or (2)(B), but only if such payment or reimbursement does not exceed the actual cost of the transportation involved plus an amount for all other traveling expenses not in excess of 125 percent of the maximum amount payable under 5 U.S.C. 5702(a) for like travel by employees of the United States;

(8) Any agreement to employ or make a grant to a government official for any period after the termination of his government service if such agreement is entered into within 90 days prior to such termination;

(9) If a government official attends or participates in a conference sponsored by a private foundation, the allocable portion of the cost of such conference and other nonmonetary benefits (for example, benefits of a professional, intellectual, or psychological nature, or benefits resulting from the publication or the distribution to participants of a record of the conference), as well as the payment or reimbursement of expenses (including reasonable advances for expenses anticipated in connection with such a conference in the near future), received by such government official as a result of such attendance or participation shall not be subject to section 4941(d)(1), so long as the conference is in furtherance of the exempt purposes of the foundation; or

(10) In the case of any government official who was on leave of absence without pay on December 31, 1969, pursuant to a commitment entered into on or before such date for the purpose of engaging in certain activities for which such individual was to be paid by one or more private foundations, any payment of compensation (or payment or reimbursement of expenses, including reasonable advances for expenses anticipated in the immediate future) by such private foundations to such individual for any continuous period after December 31, 1969, and prior to January 1, 1971, during which such individual remains on leave of absence to engage in

such activities. A commitment is considered entered into on or before December 31, 1969, if on or before such date, the amount and nature of the payments to be made and the name of the individual receiving such payments were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee orally or in writing.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7938, 49 FR 3848, Jan. 31, 1984]

§ 53.4941(d)–4 Transitional rules.

(a) *Certain transactions involving securities acquired by a foundation before May 27, 1969*—(1) *In general*. Under section 101(l)(2)(A) of the Tax Reform Act of 1969 (83 Stat. 533), any transaction between a private foundation and a corporation which is a disqualified person shall not be an act of self-dealing if such transaction is pursuant to the terms of securities of such corporation, if such terms were in existence at the time such securities were acquired by the foundation, and if such securities were acquired by the foundation before May 27, 1969.

(2) *Example*. The provisions of this paragraph may be illustrated by the following example:

Example. Private foundation X purchased preferred stock of corporation M, a disqualified person with respect to X, on March 15, 1969. The terms of such securities on such date provided that the stock could be called by M at any time if M paid the outstanding shareholders cash equal to 105 percent of the face amount of the stock. If M exercises this right and calls the stock owned by X on February 15, 1970, such call shall not constitute an act of self-dealing even if such price is not equivalent to fair market value on such date and even if not all of the securities of that class are called.

(b) *Disposition of certain business holdings*—(1) *In general*. Under section 101(l)(2)(B) of the Tax Reform Act of 1969 (83 Stat. 533), the sale, exchange, or other disposition of property which is owned by a private foundation on May 26, 1969, to a disqualified person shall not be an act of self-dealing if the foundation is required to dispose of such property in order not to be liable for tax under section 4943 (determined without regard to section 4943(c)(2)(C) and as if every disposition by the foundation were made to disqualified persons) and if such disposition satisfies the requirements of subparagraph (2) of this paragraph. For purposes of applying this paragraph in the case of a disposition completed before January 1, 1975, or after October 4, 1976, and before January 1, 1977, the amount of excess business holdings is determined under section 4943(c) without taking subsection (c)(4) into account.

(2) *Terms of the disposition*. Subparagraph (1) of this paragraph shall not apply unless:

(i) The private foundation receives an amount which equals or exceeds the fair market value of the business holdings at the time of disposition or at the time a contract for such disposition was previously executed; and

(ii) At the time with respect to which subdivision (i) of this subparagraph is applied, the transaction would not have constituted a prohibited transaction within the meaning of section 503(b) or the corresponding provisions of prior law if such provisions had been applied at such time.

(3) *Property received under a trust or will*. For purposes of this paragraph, property shall be considered as owned by a private foundation on May 26, 1969, if such property is acquired by such foundation under the terms of a will executed on or before such date, under the terms of a trust which was irrevocable on such date, or under the terms of a revocable trust executed on or before such date if the property would have passed under a will which would have met the requirements of this subparagraph but for the fact that a grantor dies without having revoked the trust. An amendment or republication of a will which was executed on or before May 26, 1969, does not prevent any interest in a business enterprise which was to pass under the terms of such will (which terms were in effect on May 26, 1969, and at all times thereafter) from being treated as owned by a private foundation on or before May 26, 1969, solely because:

(i) There is a reduction in the interest in the business enterprise which the foundation was to receive under the terms of the will (for example, if the foundation is to receive the residuary

estate and one class of stock is disposed of by the decedent during his lifetime or by a subsequent codicil),

(ii) Such amendment or republication is necessary in order to comply with section 508(e) and the regulations thereunder,

(iii) There is a change in the executor of the will, or

(iv) There is any other change which does not otherwise change the rights of the foundation with respect to such interest in the business enterprise.

However, if under such amendment or republication there is an increase of the interest in the business enterprise which the foundation was to receive under the terms of the will in effect on May 26, 1969, such increase shall not be treated as owned by the private foundation on or before May 26, 1969, but under such circumstances the interest which would have been acquired before such increase shall be treated as owned by the private foundation on or before May 26, 1969.

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

Example 1. On May 26, 1969, private foundation X owns 10 percent of corporation Y's voting stock, which is traded on the New York Stock Exchange. Disqualified persons with respect to X own an additional 40 percent of such voting stock. X is on a calendar year basis. Prior to January 1, 1975, X privately sold its entire 10 percent for cash to B, a disqualified person, at the price quoted on the stock exchange at the close of the day less commissions. Since the 10 percent owned by X would constitute excess business holdings without the application of section 4943(c) (2)(C) or (4), the disposition will not constitute an act of self-dealing.

Example 2. Assume the facts as stated in example (1), except that the only stock of corporation Y which X owns is 1.5 percent of Y's voting stock. Since the 1.5 percent owned by X would constitute excess business holdings without the application of section 4943(c) (2)(C) or (4), the disposition of the stock to B for cash will not constitute an act of self-dealing.

Example 3. Assume the facts as stated in example (1), except that B, instead of paying cash as consideration for the stock, issued a 10-year secured promissory note as consideration for the stock. The issuance of such promissory note will not be treated as an act of self-dealing until taxable years beginning after December 31, 1979, unless such issuance would have been a prohibited transaction under section 503(b), or unless the transaction does not remain throughout its life at least as favorable as an arm's-length contract negotiated currently. See paragraph (c) of this section.

(c) *Existing leases and loans*—(1) *In general*. Under section 101(1)(2)(C) of the Tax Reform Act of 1969 (83 Stat. 533), the leasing of property or the lending of money (or other extension of credit) between a disqualified person and a private foundation pursuant to a binding contract which was in effect on October 9, 1969 (or pursuant to a renewal or modification of such a contract, as described in subparagraph (2) of this paragraph), shall not be an act of self-dealing until taxable years beginning after December 31, 1979, if:

(i) At the time the contract was executed, such contract was not a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law), and

(ii) The leasing or lending of money (or other extension of credit) remains throughout the term of the lease or extension of credit at least as favorable as a current arm's-length transaction with an unrelated person.

(2) *Renewal or modification of existing contracts*. A renewal or a modification of an existing contract is referred to in subparagraph (1) of this paragraph only if any modifications of the terms of such contract are not substantial and the relative advantages of the modified contract compared with contracts entered into at arm's-length with an unrelated person at the time of the renewal or modification are at least as favorable to the private foundation as the relative advantages of the original contract compared with contracts entered into at arm's-length with an unrelated person at the time of execution of the original contract. Such renewal or modification need not be provided for in the original contract; it may take place before or after the expiration of the original contract and at any time before the first day of the first taxable year of the private foundation beginning after December 31, 1979. Where, in a normal commercial setting, an unrelated party in the position of a private foundation could be expected to insist upon a renegotiation or termination of a binding contract, the

private foundation must so act. Thus, for example, if a disqualified person leases office space from a private foundation on a month-to-month basis, and a party in the position of the private foundation could be expected to renegotiate the rent required in such contract because of a rise in the fair market value of such office space, the private foundation must so act in order to avoid participation in an act of self-dealing. Where the private foundation has no right to insist upon renegotiation, an act of self-dealing shall occur if the terms of the contract become less favorable to the foundation than an arm's-length contract negotiated currently, unless:

(i) The variation from current fair market value is de minimis, or

(ii) The contract is renegotiated by the foundation and the disqualified person so that the foundation will receive no less than fair market value. For purposes of subdivision (i) of this subparagraph de minimis ordinarily shall be no more than one-half of 1 percent in the rate of return in the case of a loan, or 10 percent of the rent in the case of a lease.

(3) *Example*. The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following example.

Example. Under a binding contract entered into on January 1, 1964, X, a private foundation, leases a building for 10 years from Z, a disqualified person. At the time the contract was executed, the lease was not a ''prohibited transaction'' within the meaning of section 503(b), since the rent charged X was only 50 percent of the rent which would have been charged in an arm's-length transaction with an unrelated person. On January 1, 1974, X renewed the lease for 5 additional years. The terms of the renewal agreement provided for a 20 percent increase in the amount of rent charged X. However, at the time of such renewal, the rent which would have been charged in an arm's-length transaction had also increased by 20 percent from that of 1964. The renewal agreement shall not be treated as an act of self-dealing.

(4) *Certain exchanges of stock or securities for bonds, debentures or other indebtedness*. (i) In the case of a transaction described in paragraph (a) or (b) of this section or paragraph (d) of §53.4941(d)–3, where a bond, debenture, or other indebtedness of a disqualified person is acquired by a private foundation in exchange for stock or securities which it held on October 9, 1969, and at all times thereafter, such indebtedness shall be treated as an extension of credit pursuant to a binding contract in effect on October 9, 1969, to which this paragraph applies. Thus, so long as the extension of credit remains at least as favorable as an arm's-length transaction with an unrelated person and neither the acquisition of the securities which were exchanged for the indebtedness nor the exchange of such securities for the indebtedness was a prohibited transaction within the meaning of section 503(b) (or the corresponding provisions of prior law) at the time of such acquisition, such extension of credit shall not be an act of self-dealing until taxable years beginning after December 31, 1979.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume the facts as stated in example (2) of §53.4941 (d)–3 (d)(2), except that the preferred stock was held by Y on October 9, 1969, and at all times thereafter until the redemption occurred on January 2, 1972. In addition, assume that the acquisition of the preferred stock was not a prohibited transaction within the meaning of section 503(b) at the time of such acquisition and the exchange of the preferred stock for the debentures would not have been a prohibited transaction within the meaning of section 503(b). For 1973 through 1979, the extension of credit arising from the holding of the debentures is not an act of self-dealing so long as the extension of credit remains at least as favorable as an arm's-length transaction with an unrelated person. See, however, example (3) of §53.4941 (e)–1 (e)(1)(ii).

Example 2. Assume the same facts as stated in example (1) of §53.4941 (d)–4 (b)(4), except that private foundation X sold its entire 10 percent of corporation Y's voting stock in exchange for Y's secured notes which mature on December 31, 1985. For taxable years beginning before January 1, 1980, the extension of credit arising from the holding of such notes by X is not an act of self-dealing so long as the extension of credit remains at least as favorable as an arm's-length transaction with an unrelated person and neither the acquisition of the securities which were exchanged for the indebtedness nor the exchange of such securities for the indebtedness was a prohibited transaction within the meaning of section 503(b) (or the corresponding provisions of prior law). Under §53.4941(e)–1, a new extension of credit occurs

on the first day of each taxable year in which an indebtedness is outstanding; therefore, if the secured notes are held by X after December 31, 1979, a new extension of credit not excepted from the definition of an act of self-dealing will occur on the first day of the first taxable year beginning after December 31, 1979, and on the first day of each succeeding taxable year in which X holds such secured notes.

(d) *Sharing of goods, services, or facilities before January 1, 1980.* (1) Under section 101(1)(2)(D) of the Tax Reform Act of 1969 (83 Stat. 533), the use (other than leasing) of goods, services, or facilities which are shared by a private foundation and a disqualified person shall not be an act of self-dealing until taxable years beginning after December 31, 1979, if:

(i) The use is pursuant to an arrangement in effect before October 9, 1969, and at all times thereafter;

(ii) The arrangement was not a prohibited transaction (within the meaning of sec. 503(b) or the corresponding provisions of prior law) at the time it was made; and

(iii) The arrangement would not be a prohibited transaction if section 503(b) continued to apply.

For purposes of this paragraph, such arrangement need not be a binding contract.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. In 1964 X, a private foundation, and B, a disqualified person, arranged for the sharing of computer time in B's son's company for a 10-year period commencing January 1, 1965. B's son has the unilateral right to terminate the arrangement at any time. X uses the computer facilities in connection with an analysis of its grant-making activities, while B's use is related to his business affairs. Both X and B make reasonable fixed payments to the computer company based on the number of hours of computer use and comparable to fees charged in arm's-length transactions with unrelated parties. The company imposes a maximum limit per month on the sum of the number of hours for which X and B use the computer facilities. Under these circumstances, the sharing of computer time is not an act of self-dealing.

(e) *Use of certain property acquired before October 9, 1969.* (1) Under section 101(1)(2)(E) of the Tax Reform Act of 1969 (83 Stat. 533), the use of property in which a private foundation and a disqualified person have a joint or common interest will not be an act of self-dealing if the interests of both in such property were acquired before October 9, 1969.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. Prior to October 9, 1969, C, a disqualified person, gave beachfront property to private foundation X for use as a recreational facility for underprivileged, inner-city children during the summer months. However, C retained the right to use such property for his life. The use of such property by C or X is not an act of self-dealing.

(f) *Disposition of leased property*—(1) *In general.* Under section 101(1)(2)(F) of the Tax Reform Act of 1969, as amended by the Tax Reform Act of 1976 (90 Stat. 1713), the sale, exchange or other disposition (other than by lease) to a disqualified person of property being leased to the disqualified person by a private foundation is not an act of self-dealing if:

(i) The private foundation is leasing substantially all of the property to the disqualified person under a lease to which paragraph (c) of this section applies;

(ii) The disposition occurs after October 4, 1976, and before January 1, 1978; and

(iii) The disposition satisfies the requirements of paragraph (f)(2) of this section.

(2) *Terms of disposition.* Paragraph (f)(1) of this section applies only if:

(i) The private foundation receives an amount that equals or exceeds the fair market value of the property either at the time of the disposition or at the time (after June 30, 1976) the contract for such disposition was executed;

(ii) In computing the fair market value of the property, no diminution of that value results from the fact that the property is subject to any lease to disqualified persons; and

(iii) At the time with respect to which paragraph (f)(2)(i) of this section is applied, the transaction would not have constituted a prohibited transaction within the meaning of section 503(b) or the corresponding provisions of prior law if those provisions had

been applied at the time of the transaction.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7678, 45 FR 12416, Feb. 26, 1980]

§ 53.4941(e)–1 Definitions.

(a) *Taxable period*—(1) *In general*. For purposes of any act of self-dealing, the term ''taxable period'' means the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed by section 4941(a)(1),

(ii) The date on which correction of the act of self-dealing is completed, or

(iii) The date on which the tax imposed by section 4941(a)(1) is assessed.

(2) *Date of occurrence*. An act of self-dealing occurs on the date on which all the terms and conditions of the transaction and the liabilities of the parties have been fixed. Thus, for example, if a private foundation gives a disqualified person a binding option on June 15, 1971, to purchase property owned by the foundation at any time before June 15, 1972, the act of self-dealing has occurred on June 15, 1971. Similarly, in the case of a conditional sales contract, the act of self-dealing shall be considered as occurring on the date the property is transferred subject only to the condition that the buyer make payment for receipt of such property.

(3) *Special rule*. Where a notice of deficiency referred to in subparagraph (1)(i) of this paragraph is not mailed because a waiver of the restrictions on assessment and collection of a deficiency has been accepted, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

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

Example 1. On July 16, 1970, F, a manager of private foundation X acting on behalf of the foundation, knowing his act to be one of self-dealing, willfully and without reasonable cause engaged in an act of self-dealing by selling certain real estate to A, a disqualified person. On March 25, 1973, the Internal Revenue Service mailed a notice of deficiency to A with respect to the tax imposed on the sale under section 4941(a)(1). The taxable period with respect to the act of self-dealing for both A and F is July 16, 1970, through March 25, 1973.

Example 2. Assume the facts as stated in example (1), except that the act of self-dealing is corrected by A on March 17, 1971. The taxable period with respect to the act of self-dealing for both A and F is July 16, 1970, through March 17, 1971.

Example 3. Assume the facts as stated in example (1), except that on August 20, 1972, A files a waiver of the restrictions on assessment and collection of the tax imposed on the sale under section 4941(a)(1) which is accepted. The taxable period with respect to the act of self-dealing for both A and F is July 16, 1970, through August 20, 1972.

(b) *Amount involved*—(1) *In general*. Except as provided in subparagraph (2) of this paragraph, for purposes of any act of self-dealing, the term ''amount involved'' means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.

(2) *Exceptions*. (i) In the case of the payment of compensation for personal services to persons other than Government officials, the amount involved shall be only the excess compensation paid by the private foundation.

(ii) Where the use of money or other property is involved, the amount involved shall be the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used. Thus, for example, in the case of a lease of a building by a private foundation to a disqualified person, the amount involved is the greater of the amount of rent received by the private foundation from the disqualified person or the fair rental value of the building for the period such building is used by the disqualified person.

(iii) In cases in which a transaction would not have been an act of self-dealing had the private foundation received fair market value, the amount involved is the excess of the fair market value of the property transferred by the private foundation over the amount which the private foundation receives, but only if the parties have made a good faith effort to determine fair market value. For purposes of this subdivision a good faith effort to determine fair market

value shall ordinarily have been made where:

(*a*) The person making the valuation is not a disqualified person with respect to the foundation and is both competent to make the valuation and not in a position, whether by stock ownership or otherwise, to derive an economic benefit from the value utilized, and

(*b*) The method utilized in making the valuation is a generally accepted method for valuing comparable property, stock, or securities for purposes of arm's-length business transactions where valuation is a significant factor.

See section 4941(d)(2)(F) and §§ 53.4941(d)–1(b)(3), 53.4941(d)–3 (d)(1) and 53.4941(d)–4(b). Thus, for example, if a corporation which is a disqualified person with respect to a private foundation recapitalizes in a transaction which would be described in section 4941(d)(2)(F) but for the fact that the private foundation receives new stock worth only $95,000 in exchange for the stock which it previously held in the corporation and which has a fair market value of $100,000 at the time of the recapitalization, the amount involved would be $5,000 ($100,000—$95,000) if there had been a good faith attempt to value the stock. Similarly, if an estate enters into a transaction with a disqualified person with respect to a foundation and such transaction would be described in § 53.4941(d)–1(b)(3) but for the fact that the estate receives less than fair market value for the property exchanged, the amount involved is the excess of the fair market value of the property the estate transfers to the disqualified person over the money and the fair market value of the property received by the estate.

(3) *Time for determining fair market value.* The fair market value of the property or the use thereof, as the case may be, shall be determined as of the date on which the act of self-dealing occurred in the case of the initial taxes imposed by section 4941(a) and shall be the highest fair market value during the taxable period in the case of the additional taxes imposed by section 4941(b).

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

Example 1. A, a disqualified person with respect to private foundation M, uses an airplane owned by M on June 15 and June 16, 1970, for a 2-day trip to New York City on personal business and pays M $500 for the use of such airplane. The fair rental value for the use of the airplane for those 2 days is $3,000. For purposes of section 4941(a), the amount involved with respect to the act of self-dealing is $3,000.

Example 2. On April 10, 1970, B, a manager of private foundation P, borrows $100,000 from P at 6 percent interest per annum. Both principal and interest are to be paid 1 year from the date of the loan. The fair market value of the use of the money on April 10, 1970, is 10 percent per annum. Six months later, B and P terminate the loan, and B repays the $100,000 principal plus $3,000 ($100,000×6 percent for one-half year) interest. For purposes of section 4941(a), the amount involved with respect to the act of self-dealing is $5,000 ($100,000×10 percent for one-half year) for each year or partial year in the taxable period.

Example 3. C, a substantial contributor to private foundation S, leases office space in a building owned by S for $3,600 for 1 year beginning on January 1, 1971. The fair rental value of the building for a 1-year lease on January 1, 1971, is $5,600. On December 31, 1971, the lease is terminated. For purposes of section 4941(a), the amount involved with respect to the act of self-dealing is $5,600 for each year or partial year in the taxable period.

Example 4. D, a disqualified person with respect to private foundation T, purchases 100 shares of stock from T for $5,000 on June 15, 1982. The fair market value of the 100 shares of stock on that date is $4,800. D sells the 100 shares of stock on December 20, 1983, for $6,000. On December 27, 1983, a notice of deficiency with respect to the taxes imposed under subsections (a) and (b) of section 4941 is mailed to D and the taxable period ends. D fails to correct during the taxable period. Between June 15, 1982, and the end of the taxable period, the stock was quoted on the New York Stock Exchange at a high of $67 per share. The amount involved with respect to the tax imposed under subsection (a) is $5,000, and the amount involved with respect to the tax imposed under subsection (b) for failure to correct is $6,700 (100 shares at $67 per share), the highest fair market value during the taxable period.

Example 5. Corporation M, a disqualified person with respect to private foundation V, redeems all of its Class B common stock, some of which is held by V. The redemption of V's stock would be described in section 4941(d)(2)(F) but for the fact that V receives only $95,000 in exchange for stock which has a fair market value of $100,000 at the time of the transaction. The $95,000 value of V's

stock, which is not publicly traded, was determined by investment bankers in accordance with accepted methods of valuation that would be utilized if the M stock held by V were to be offered for sale to the public. Therefore, the amount involved with respect to the transaction will ordinarily be limited to $5,000 ($100,000—$95,000).

(c) *Correction*—(1) *In general*. Correction shall be accomplished by undoing the transaction which constituted the act of self-dealing to the extent possible, but in no case shall the resulting financial position of the private foundation be worse than that which it would be if the disqualified person were dealing under the highest fiduciary standards. For example, where a disqualified person sells property to a private foundation for cash, correction may be accomplished by recasting the transaction in the form of a gift by returning the cash to the foundation. Subparagraphs (2) through (6) of this paragraph illustrate the minimum standards of correction in the case of certain specific acts of self-dealing. Principles similar to the principles contained in such subparagraphs shall be applied with respect to other acts of self-dealing. Any correction pursuant to this paragraph and section 4941 shall not be an act of self-dealing.

(2) *Sales by foundation*. (i) In the case of a sale of property by a private foundation to a disqualified person for cash, undoing the transaction includes, but is not limited to, requiring recission of the sale where possible. However, in order to avoid placing the foundation in a position worse than that in which it would be if rescission were not required, the amount returned to the disqualified person pursuant to the rescission shall not exceed the lesser of the cash received by the private foundation or the fair market value of the property received by the disqualified person. For purposes of the preceding sentence, fair market value shall be the lesser of the fair market value at the time of the act of self-dealing or the fair market value at the time of rescission. In addition to rescission, the disqualified person is required to pay over to the private foundation any net profits he realized after the original sale with respect to the property he received from the sale. Thus, for example, the disqualified person must pay over to the foundation any income derived by him from the property he received from the original sale to the extent such income during the correction period exceeds the income derived by the foundation during the correction period from the cash which the disqualified person originally paid to the foundation.

(ii) If, prior to the end of the correction period, the disqualified person resells the property in an arm's-length transaction to a bona fide purchaser who is not the foundation or another disqualified person, no rescission is required. In such case, the disqualified person must pay over to the foundation the excess (if any) of the greater of the fair market value of such property on the date on which correction of the act of self-dealing occurs or the amount realized by the disqualified person from such arm's length resale over the amount which would have been returned to the disqualified person pursuant to subdivision (i) of this subparagraph if rescission had been required. In addition, the disqualified person is required to pay over to the foundation any net profits he realized, as described in subdivision (i) of this subparagraph.

(iii) *Examples*. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On July 1, 1970, private foundation M sold a painting to A, a disqualified person, for $5,000, in a transaction not within any of the exceptions to self-dealing. The fair market value of the painting on such date was $6,000. On March 25, 1971, the painting is still owned by A and has a fair market value of $7,200. A did not derive any income as a result of purchasing the painting. In order to correct the act of self-dealing under this subparagraph on March 25, 1971, the sale must be rescinded by the return of the painting to M. However, pursuant to such rescission, M must not pay A more than $5,000, the original consideration received by M.

Example 2. Assume the facts as stated in Example (1), except that A sold the painting on December 15, 1970, in an arm's-length transaction to C, a bona fide purchaser who is not a disqualified person, for $6,100. In addition, assume that the fair market value of the painting on March 25, 1971, is $7,600. In order to correct the act of self-dealing under this subparagraph on March 25, 1971, A must pay M $2,600 ($7,600, the fair market value at the time of correction, less $5,000, the amount which would have been returned to A if rescission had been required). Since the

painting was sold to C in an arm's-length transaction prior to correction, no rescission is required.

(3) *Sales to foundation.* (i) In the case of a sale of property to a private foundation by a disqualified person for cash, undoing the transaction includes, but is not limited to, requiring rescission of the sale where possible. However, in order to avoid placing the foundation in a position worse than that in which it would be if rescission were not required, the amount received from the disqualified person pursuant to the rescission shall be the greatest of the cash paid to the disqualified person, the fair market value of the property at the time of the original sale, or the fair market value of the property at the time of rescission. In addition to rescission, the disqualified person is required to pay over to the private foundation any net profits he realized after the original sale with respect to the consideration he received from the sale. Thus, for example, the disqualified person must pay over to the foundation any income derived by him from the cash he received from the original sale to the extent such income during the correction period exceeds the income derived by the foundation during the correction period from the property which the disqualified person originally transferred to the foundation.

(ii) If, prior to the end of the correction period, the foundation resells the property in an arm's-length transaction to a bona fide purchaser who is not a disqualified person, no rescission is required. In such case, the disqualified person must pay over to the foundation the excess (if any) of the amount which would have been received from the disqualified person pursuant to subdivision (i) of this subparagraph, if recission had been required over the amount realized by the foundation upon resale of the property. In addition, the disqualified person is required to pay over to the foundation any net profits he realized, as described in subdivision (i) of this subparagraph.

(iii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On February 10, 1972, D, a disqualified person with respect to private foundation P, sells 100 shares of X stock to P for $2,500 in a transaction which does not fall within any of the exceptions to selfdealing. The fair market value of the 100 shares of X stock on February 10, 1972, is $3,200. On June 1, 1973, the 100 shares of X stock have a fair market value of $2,900. From February 10, 1972, through June 1, 1973, P has received dividends of $90 from the stock, and D has received interest of $300 from the $2,500 which D received as consideration for the stock. In order to correct the act of self-dealing under this subparagraph on June 1, 1973, the sale must be rescinded by the return of the stock to D. However, pursuant to such rescission, D must pay P $3,200, the fair market value of the stock on the date of sale. In addition, D must pay P $210, the amount of income derived by D during the correction period from the $2,500 received from P ($300) minus the income derived by P during the correction period from the stock sold to P ($90).

Example 2. Assume the facts as stated in Example (1), except that on September 1, 1972, P sells the 100 shares of X stock to E, a bona fide purchaser who is not a disqualified person, in an arm's-length transaction for $2,750. Assume further that P has not received any dividends from the stock prior to the sale to E, but that P receives interest of $260 from the $2,750 received as consideration for the stock for the period from September 1, 1972, to June 1, 1973. In order to correct the act of self-dealing under this subparagraph on June 1, 1973, D must pay P $450 ($3,200, the amount which would have been received from D if rescission had been required, less $2,750, the amount realized by P from the sale to E). In addition, D must pay P $40, the amount of income derived by D during the correction period from the $2,500 received from P ($300) minus the income derived by P during the correction period from the stock sold to P ($260 from the $2,750 received as consideration for the stock). Since the stock was sold to E in an arm's-length transaction prior to correction, no rescission is required.

(4) *Use of property by a disqualified person.* (i) In the case of the use by a disqualified person of property owned by a private foundation, undoing the transaction includes, but is not limited to, terminating the use of such property. In addition to termination, the disqualified person must pay the foundation:

(*a*) The excess (if any) of the fair market value of the use of the property over the amount paid by the disqualified person for such use until such termination, and

(*b*) The excess (if any) of the amount which would have been paid by the disqualified person for the use of the property on or after the date of such termination, for the period such disqualified person would have used the property (without regard to any further extensions or renewals of such period) if such termination had not occurred, over the fair market value of such use for such period.

In applying (*a*) of this subdivision the fair market value of the use of property shall be the higher of the rate (that is, fair rental value per period in the case of use of property other than money or fair interest rate in the case of use of money) at the time of the act of self-dealing (within the meaning of paragraph (e)(1) of this section) or such rate at the time of correction of such act of self-dealing. In applying (*b*) of this subdivision the fair market value of the use of property shall be the rate at the time of correction.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On January 1, 1972, private foundation S rented the third story of its office building to A, a disqualified person, for 1 year at an annual rent of $10,000, in a transaction not within any of the exceptions to self-dealing. Both S and A are on the calendar year basis. The fair rental value of such office space for a 1-year period on January 1, 1972, is $12,000. On June 30, 1972, the fair rental value of such office space for a 1-year period is $13,000. In order to correct the act of self-dealing under this subparagraph on June 30, 1972, A must terminate his use of the property. In addition, A must pay S $1,500, the excess of $6,500 (the fair rental value for 6 months as of June 30, 1972) over $5,000 (the amount paid to S from Jan. 1, 1972, to June 30, 1972).

Example 2. On January 1, 1972, private foundation R rented the fourth story of its office building to B, a disqualified person, for 1 year at an annual rent of $10,000, in a transaction not included in any of the exceptions to self-dealing. Both R and B are on the calendar year basis. On January 1, 1973, B continues to rent the office space as a periodic tenant paying his rent monthly at an annual rate of $10,000. The fair rental value of such office space for a 1-year period on January 1, 1972, is $12,000, and as of January 1, 1973, is $1,250 per month. As of December 31, 1973, the fair rental value of such office space is $14,000 for a 1-year period and $1,200 on a monthly basis. In order to correct his acts of self-dealing (within the meaning of paragraph (e)(1) of this section) under this subparagraph on December 31, 1973, B must terminate his use of the property. In addition, B must pay R $9,000, $4,000 for his use of the property for 1972 (the excess of $14,000, the fair rental value for 1 year as of Dec. 31, 1973, over $10,000, the amount B paid R for his use of the property for 1972) and $5,000 for his use of the property for 1973 (the excess of $15,000, the fair rental value for 12 months as of Jan. 1, 1973, over $10,000, the amount B paid R for his use of the property for 1973).

Example 3. B, a substantial contributor to private foundation T, leases office space in a building owned by T for $5,000 for 1 year beginning on November 10, 1972, in a transaction not included in any of the exceptions to self-dealing. The fair rental value of the building for a 1-year period on November 10, 1972, is $4,000. On May 10, 1973, the fair rental value of the building for the remaining period of the lease is $2,200. In order to correct the acts of self-dealing under this subparagraph on May 10, 1973, B and T must terminate the lease. In addition, B must pay T $300 (the excess of $2,500, the amount which would have been paid by B for the remaining period of the lease if it had not been terminated, over $2,200, the fair rental value at the time of correction for the remaining period of the lease).

(5) *Use of property by a private foundation.* (i) In the case of the use by a private foundation of property owned by a disqualified person, undoing the transaction includes, but is not limited to, terminating the use of such property. In addition to termination, the disqualified person must pay the foundation:

(*a*) The excess (if any) of the amount paid to the disqualified person for such use until such termination over the fair market value of the use of the property, and

(*b*) The excess (if any) of the fair market value of the use of the property, for the period the foundation would have used the property (without regard to any further extensions or renewals of such period) if such termination had not occurred, over the amount which would have been paid to the disqualified person on or after the date of such termination for such use for such period.

In applying (*a*) of this subdivision the fair market value of the use of property shall be the lesser of the rate (that is, fair rental value per period in the case of use of property other than

money or fair interest rate in the case of use of money) at the time of the act of self-dealing (within the meaning of paragraph (e)(1) of this section) or such rate at the time of correction of such act of self-dealing. In applying (*b*) of this subdivision the fair market value of the use of property shall be the rate at the time of correction.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On July 1, 1972, private foundation X leases office space in a building owned by C, a disqualified person, for 1 year at an annual rent of $6,000. Both X and C are on the calendar year basis. The fair rental value of such office space for a 1-year period as of July 1, 1972, is $4,200. As of January 1, 1973, the fair rental value of such office space for a 1-year period is $5,400, and as of June 30, 1973, the fair rental value of such office space for a 1-year period is $4,800. In order to correct his acts of self-dealing (within the meaning of paragraph (e)(1) of this section) under this subparagraph on June 30, 1973, C must terminate X's use of the property. In addition, C must pay X $1,500, $900 (the excess of $3,000, the amount paid to C from July 1, 1972, through December 31, 1972, over $2,100, the fair rental value for 6 months as of July 1, 1972) plus $600 (the excess of $3,000, the amount paid to C from January 1, 1973, through June 30, 1973, over $2,400, the fair rental value for 6 months as of June 30, 1973).

Example 2. On April 1, 1973, D, a disqualified person with respect to private foundation Y, loans $100,000 to Y at 6 percent interest per annum. Both principal and interest are to be paid on April 1, 1978. The fair market value of the use of the money on April 1, 1973, is 9 percent per annum. On April 1, 1974, D and Y terminate the loan. On such date, the fair market value of the use of $100,000 is 10 percent per annum. In order to correct the act of self-dealing on April 1, 1974, in addition to the termination of the loan from D to Y, D must pay Y $16,000, the excess of $40,000 ($100,000×10 percent, the fair market value of the use determined at the time of correction, from April 1, 1974, to April 1, 1978) over $24,000 (the amount of interest Y would have paid to D from April 1, 1974, to April 1, 1978, if the loan from D to Y had not been terminated).

(6) *Payment of compensation to a disqualified person.* In the case of the payment of compensation by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of such foundation, undoing the transaction requires that the disqualified person pay to the foundation any amount which is excessive. However, termination of the employment or independent contractor relationship is not required.

(7) *Special rule for correction of valuation errors.* (i) In the case of a transaction described in paragraph (b)(2)(iii) of this section, a ''correction'' of the act of self-dealing shall ordinarily be deemed to occur if the foundation is paid an amount of money equal to the amount involved (as defined in paragraph (b)(2)(iii) of this section) plus such additional amounts as are necessary to compensate it for the loss of the use of the money or other property during the period commencing on the date of the act of self-dealing and ending on the date the transaction is corrected pursuant to this subparagraph.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in example (5) of paragraph (b)(4) of this section. Such transaction shall be considered as corrected by a payment of $5,000 by M to V, together with an additional payment to V of an amount equal to the interest which V could have obtained on $5,000 for the period commencing on the date of the redemption and ending on the date the act is corrected.

(d) *Cross reference.* For rules relating to taxable events that are corrected within the correction period, defined in section 4963 (e), see section 4961 (a), and the regulations thereunder.

(e) *Act of self-dealing*—(1) *Number of acts; use of money or property*—(i) *In general.* If a transaction between a private foundation and a disqualified person is determined to be self-dealing (as defined in section 4941(d)), for purposes of section 4941 there is generally one act of self-dealing. For the date on which such act is treated as occurring, see paragraph (a)(2) of this section. If, however, such transaction relates to the leasing of property, the lending of money or other extension of credit, other use of money or property, or payment of compensation, the transaction will generally be treated (for purposes of section 4941 but not section 507 or section 6684) as giving rise to an act of self-dealing on the day the transaction occurs plus an act of self-dealing on the

first day of each taxable year or portion of a taxable year which is within the taxable period and which begins after the taxable year in which the transaction occurs.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On August 31, 1970, X, a private foundation, sells a building to A, a disqualified person with respect to X. A is on the calendar year basis. Under these circumstances, the transaction between A and X is one act of self-dealing which is treated for purposes of section 4941 as occurring on August 31, 1970.

Example 2. Assume the facts as stated in example (1), except that, instead of selling the building to A, X leases the building to A for a term of 4 years beginning July 31, 1970, at an annual rental of $12,000. The fair rental value of the building is also $12,000 per annum as of July 31, 1970, and throughout the next 4 years. This transaction is corrected on September 30, 1973, in accordance with paragraph (c)(4) of this section. Under these circumstances, the transaction between A and X constitutes four separate acts of self-dealing, which are treated for purposes of section 4941 as occurring on July 31, 1970, January 1, 1971, January 1, 1972, and January 1, 1973. Consequently, there are four taxable periods. The first taxable period is from July 31, 1970, to September 30, 1973; the second is from January 1, 1971, to September 30, 1973; the third is from January 1, 1972, to September 30, 1973; and the fourth is from January 1, 1973, to September 30, 1973. For purposes of the initial taxes in section 4941(a), the amount involved is $5,000 for the first taxable period, $12,000 for the second, $12,000 for the third, and $9,000 for the fourth. The initial taxes to be paid by A are thus $1,000 ($5,000×5%×4 taxable years or partial taxable years in the taxable period) for the first act; $1,800 ($12,000×5%×3) for the second act; $1,200 ($12,000×5%×2) for the third act; and $450 ($9,000×5%×1) for the fourth act.

Example 3. Assume the facts as stated in example (1) of § 53.4941(d)–4(c)(4)(ii). If the debentures are held by Y after December 31, 1979, the extension of credit will not be excepted from the definition of an act of self-dealing, because an act of self-dealing will be treated (for purposes of section 4941) as occurring on January 1, 1980.

(2) *Number of acts; joint participation by disqualified persons*—(i) *In general.* If joint participation in a transaction by two or more disqualified persons constitutes self-dealing (such as a joint sale of property to a private foundation or joint use of its money or property), such transaction shall generally be treated as a separate act of self-dealing with respect to each disqualified person for purposes of section 4941. For purposes of section 507 and, in the case of a foundation manager, section 6684, however, such transaction shall be treated as only one act of self-dealing. For purposes of this subparagraph, an individual and one or more members of his family (within the meaning of section 4946(d)) shall be treated as one person, regardless of whether a member of the family is a disqualified person not only by reason of section 4946(a)(1)(D) but also by reason of another subparagraph of section 4946(a)(1). However, the liability imposed on a disqualified person and one or more members of his family for joint participation in an act of self-dealing shall be joint and several in accordance with section 4941(c)(1) and § 53.4941(c)–1(a).

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Private foundation X permits A, a substantial contributor to X, and her spouse, H, to use an automobile owned by X and normally used in its foundation activities to travel from State Z to State Y for a vacation on December 1, 1971. The automobile is then returned to X until December 21, 1971, when X again permits them to use the automobile to return to their home in State Z. Under these circumstances, there is one act of self-dealing on December 1, 1971, and a second act of self-dealing on December 21, 1971.

Example 2. Assume the facts as stated in example (1), except that B joined A and H on their vacation and traveled with them both to and from State Y. B is a disqualified person with respect to X, but he is not related by blood or marriage to A or H. Assume also that X is not paid for the use of its automobile, but that the fair rental value during the taxable period is $300 (or $100 per person) for a one-way trip between State Y and State Z. Under these circumstances, there are four acts of self-dealing, two with respect to A and H and two with respect to B. The amount involved with respect to A and H is $200 for each act, and the amount involved with respect to B is $100 for each act.

(f) *Fair market value.* For purposes of §§ 53.4941(a)–1 through 53.4941 (f)–1, fair market value shall be determined pursuant to the provisions of § 53.4942(a)–2 (c)(4).

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 8084, 51 FR 16301, May 2, 1986]

§ 53.4941(f)–1 Effective dates.

(a) *In general*. Except as provided in paragraph (b) of this section, §§ 53.4941(a)–1 through 53.4941(e)–1 shall apply to all acts of self-dealing engaged in after December 31, 1969.

(b) *Transitional rules*—(1) *Commitments made prior to January 1, 1970, between private foundations and government officials*. Section 4941 shall not apply to a payment for one or more purposes described in section 170(c) (1) or (2)(B) made on or after January 1, 1970, by a private foundation to a government official, if such payment is made pursuant to a commitment entered into prior to such date, but only if such commitment was made in accordance with the foundation's usual practices and is reasonable in amount in light of the purposes of the payment. For purposes of this subparagraph, a commitment will be considered entered into prior to January 1, 1970, if prior to such date, the amount and nature of the payments to be made and the name of the payee were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee in writing.

(2) *Special transitional rule*. In the case of an act of self-dealing engaged in prior to July 5, 1971, section 4941(a) (1) shall not apply if:

(i) The participation (as defined in § 53.4941(a)–1(a)(3)) by the disqualified person in such act is not willful and is due to reasonable cause (as defined in § 53.4941(a)–1(b) (4) and (5)),

(ii) The transaction would not be a prohibited transaction if section 503(b) applied, and

(iii) The act is corrected (within the meaning of § 53.4941(e)–1(c)) within a period ending [insert 90 days after date on which final regulations under section 4941 are filed by the Federal Register], extended (prior to the expiration of the original period) by any period which the Commissioner determines is reasonable and necessary (within the meaning of § 53.4941(e)–1(d)) to bring about correction of the act of self-dealing.

Subpart C—Taxes on Failure To Distribute Income

SOURCE: T.D. 7249, 38 FR 768, Jan. 4, 1973, unless otherwise noted.

§ 53.4942(a)–1 Taxes for failure to distribute income.

(a) *Imposition of tax*—(1) *Initial tax*. Except as provided in paragraph (b) of this section, section 4942(a) imposes an excise tax of 15 percent on the undistributed income (as defined in paragraph (a) of § 53.4942(a)–2) of a private foundation for any taxable year which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period as defined in paragraph (c)(1) of this section). For purposes of section 4942 and this section, the term *distributed* means distributed as qualifying distributions under section 4942(g). See paragraph (d)(2) of § 53.4942(a)–3 with respect to correction of deficient distributions for prior taxable years.

(2) *Additional tax*. In any case in which an initial excise tax is imposed by section 4942(a) on the undistributed income of a private foundation for any taxable year, section 4942(b) imposes an additional excise tax on any portion of such income remaining undistributed at the close of the correction period (as defined in paragraph (c)(1) of this section). The tax imposed by section 4942(b) is equal to 100 percent of the amount remaining undistributed at the close of the taxable period.

(3) *Payment of tax*. Payment of the excise taxes imposed by section 4942 (a) or (b) is in addition to, and not in lieu of, making the distribution of such undistributed income as required by section 4942. See section 507(a)(2) and the regulations thereunder.

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

Example 1. M, a private foundation which uses the calendar year as its taxable year, has at the end of 1981, $50,000 of undistributed income (as defined in paragraph (a) of § 53.4942 (a)–2) for 1981. As of January 1, 1983, $40,000 is still undistributed. On August 15, 1983, a notice of deficiency with respect to the excise taxes imposed by section 4942 (a)

and (b) is mailed to *M* under section 6212 (a) and the taxable period ends. Thus, under these facts, an initial excise tax of $6,000 (15 percent of $40,000) is imposed upon *M*. An additional excise tax of $40,000 (100 percent of $40,000) is imposed by section 4942(b). Under section 4961(a), however, if the undistributed income is reduced to zero during the correction period, this latter tax will not be assessed, and if assessed, it will be abated, and if collected, it will be credited or refunded as an overpayment.

Example 2. Assume the facts as stated in example (1), except that the notice of deficiency is mailed to *M* on September 7, 1984, and as of January 1, 1984, only $10,000 of the $50,000 of undistributed income with respect to 1981 is undistributed. Therefore, initial excise taxes of $6,000 (15 percent of $40,000, M's undistributed income from 1981, as of January 1, 1983) and $1,500 (15 percent of $10,000, *M's* undistributed income from 1981 as of January 1, 1984) are imposed by section 4942(a). If the $10,000 remains undistributed as of September 7, 1984, the end of the taxable period, an additional excise tax of $10,000 (100 percent of $10,000, *M's* undistributed income from 1981, as of September 7, 1984) is imposed by section 4942(b).

(b) *Exceptions*—(1) *In general.* The initial excise tax imposed by section 4942(a) shall not apply to the undistributed income of a private foundation:

(i) For any taxable year for which it is an operating foundation (as defined in section 4942(j)(3) and the regulations thereunder), or

(ii) To the extent that the foundation failed to distribute any amount solely because of incorrect valuation of assets under paragraph (c)(4) of § 53.4942(a)–2, if:

(*a*) The failure to value the assets properly was not willful and was due to reasonable cause,

(*b*) Such amount is distributed as qualifying distributions (within the meaning of paragraph (a) of § 53.4942 (a)–3) by the foundation during the allowable distribution period (as defined in paragraph (c)(2) of this section),

(*c*) The foundation notifies the Commissioner that such amount has been distributed (within the meaning of subdivision (ii)(*b*) of this subparagraph) to correct such failure, and

(*d*) Such distribution is treated under paragraph (d)(2) of § 53.4942(a)–3 as made out of the undistributed income for the taxable year for which a tax would (except for this subdivision) have been imposed by section 4942(a).

(2) *Improper valuation.* For purposes of subparagraph (1)(ii) of this paragraph, failure to value an asset properly shall be regarded as ''not willful'' and ''due to reasonable cause'' whenever, under all the facts and circumstances, the foundation can show that it has made all reasonable efforts in good faith to value such an asset in accordance with the provisions of paragraph (c)(4) of § 53.4942(a)–2. If a foundation, after full disclosure of the factual situation, obtains a bona fide appraisal of the fair market value of an asset by a person qualified to make such an appraisal (whether or not such a person is a disqualified person with respect to the foundation), and such foundation relies upon such appraisal, then failure to value the asset properly shall ordinarily be regarded as ''not willful'' and ''due to reasonable cause''. Notwithstanding the preceding sentence, the failure to obtain such a bona fide appraisal shall not, by itself, give rise to any inference that a foundation's failure to value an asset properly was willful or not due to reasonable cause.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. In 1976 M, a private foundation which was established in 1975 and which uses the calendar year as the taxable year, incorrectly values its assets under paragraph (c)(4) of § 53.4942(a)–2 in a manner which is not willful and is due to reasonable cause. As a result of the incorrect valuation of assets, $20,000 which should be distributed with respect to 1976 is not distributed, and as of January 1, 1978, such amount is still undistributed. On March 29, 1978, a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) is mailed to M under section 6212(a). On May 5, 1978 (within the allowable distribution period), M makes a qualifying distribution of $20,000 which is treated under paragraph (d)(2) of § 53.4942(a)–3 as made out of M's undistributed income for 1976. M notifies the Commissioner of its action. Under the stated facts, an initial excise tax of $3,000 (15 percent of $20,000) would (except for the exception contained in subparagraph (1)(ii) of this paragraph) have been imposed by section 4942(a), but since all of the requirements of such subparagraph are satisfied no tax is imposed by section 4942(a).

(c) *Certain periods.* For purposes of this section—

(1) *Taxable period.* (i) The term ''taxable period'' means, with respect to the undistributed income of a private foundation for any taxable year, the period beginning with the first day of the taxable year and ending on the earlier of:

(A) The date of mailing of a notice of deficiency under section 6212(a) with respect to the initial excise tax imposed under section 4942(a), or

(B) The date on which the initial excise tax imposed under section 4942(a) is assessed.

For example, assume M, a private foundation which uses the calendar year as the taxable year, has $15,000 of undistributed income for 1981. A notice of deficiency is mailed to M under section 6212(a) on June 1, 1983. With respect to the undistributed income of M for 1981, the taxable period began on January 1, 1981, and ended on June 1, 1983.

(ii) Where a notice of deficiency referred to in subdivision (i) of this subparagraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

(2) *Allowable distribution period.* (i) The term ''allowable distribution period'' means the period beginning with the first day of the first taxable year following the taxable year in which the incorrect valuation of foundation assets (described in paragraph (b)(1)(ii) of this section) occurred and ending 90 days after the date of mailing of a notice of deficiency under section 6212(a) with respect to the initial excise tax imposed by section 4942(a). This period shall be extended by any period in which a deficiency cannot be assessed under section 6213(a), and any other period which the Commissioner determines is reasonable and necessary to permit a distribution of undistributed income under section 4942.

(ii) Where a notice of deficiency referred to in subdivision (i) of this subparagraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the allowable distribution period.

(3) *Cross reference.* For rules relating to taxable events that are corrected within the correction period, defined in section 4963(e), see section 4961 (a) and the regulations thereunder.

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

Example 1. In 1975 M, a private foundation which uses the calendar year as the taxable year, made an error in valuing its assets which was not willful and was due to reasonable cause. The error caused M not to distribute $25,000 that should have been distributed with respect to 1975. On March 1, 1978, a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) was mailed to M under section 6212(a). With respect to the undistributed income for 1975, the *taxable period* is the period from January 1, 1975, through March 1, 1978, and the *allowable distribution period* is the period from January 1, 1976, through May 30, 1978 (90 days after the mailing of the notice of deficiency).

Example 2. Assume the facts as stated in example (1), except that the Commissioner determines that it is reasonable and necessary to extend the period for distribution through June 15, 1978. Thus, the *allowable distribution period* is from January 1, 1976, through June 15, 1978.

(d) *Effective date.* Except as otherwise specifically provided, section 4942 and the regulations thereunder shall only apply with respect to taxable years beginning after December 31, 1969.

[T.D. 7256, 38 FR 3317, Feb. 7, 1973, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4942(a)–2 Computation of undistributed income.

(a) *Undistributed income.* For purposes of section 4942, the term ''undistributed income'' means, with respect to any private foundation for any taxable year as of any time, the amount by which:

(1) The distributable amount (as defined in paragraph (b) of this section) for such taxable year, exceeds

(2) The qualifying distributions (as defined in § 53.4942(a)–3) made before such time out of such distributable amount.

(b) Distributable amount—(1) In general. For purposes of paragraph (a) of this section, the term ''distributable amount'' means:

(i) For taxable years beginning before January 1, 1982, an amount equal to the

greater of the minimum investment return (as defined in paragraph (c) of this section) or the adjusted net income (as defined in paragraph (d) of this section); and

(ii) For taxable years beginning after December 31, 1981, an amount equal to the minimum investment return (as defined in paragraph (c) of this section), reduced by the sum of the taxes imposed on such private foundation for such taxable year under subtitle A of the Code and section 4940, and increased by the amounts received from trusts described in subparagraph (2) of this paragraph.

(2) *Certain trust amounts*—(i) *In general*. The distributable amount shall be increased by the income portion (as defined in subdivision (ii) of this subparagraph) of distributions from trusts described in section 4947(a)(2) with respect to amounts placed in trust after May 26, 1969. If such distributions are made with respect to amounts placed in trust both on or before and after May 26, 1969, such distributions shall be allocated between such amounts to determine the extent to which such distributions shall be included in the foundation's distributable amount. For rules relating to the segregation of amounts placed in trust on or before May 26, 1969, from amounts placed in trust after such date and to the allocation of income derived from such amounts, see paragraph (c) (5) of § 53.4947–1.

(ii) *Income portion of distributions to private foundations*. For purposes of subdivision (i) of this subparagraph, the income portion of a distribution from a section 4947(a)(2) trust to a private foundation in a particular taxable year of such foundation shall be the greater of:

(*a*) The amount of such distribution which is treated as income (within the meaning of section 643(b)) of the trust, or

(*b*) The guaranteed annuity, or fixed percentage of the fair market value of the trust property (determined annually), which the private foundation is entitled to receive for such year, regardless of whether such amount is actually received in such year or in any prior or subsequent year.

(iii) *Limitation*. Notwithstanding subdivisions (i) and (ii) of this subparagraph, a private foundation shall not be required to distribute a greater amount for any taxable year than would have been required (without regard to this subparagraph) for such year had the corpus of the section 4947(a) (2) trust to which the distribution described in subdivision (ii) of this subparagraph is attributable been taken into account by such foundation as an asset described in paragraph (c) (1) (i) of this section.

(c) *Minimum investment return*—(1) *In general*. For purposes of paragraph (b) of this section, the ''minimum investment return'' for any private foundation for any taxable year is the amount determined by multiplying:

(i) The excess of the aggregate fair market value of all assets of the foundation, other than those described in subparagraph (2) or (3) of this paragraph, over the amount of the acquisition indebtedness with respect to such assets (determined under section 514(c)(1), but without regard to the taxable year in which the indebtedness was incurred), by

(ii) The applicable percentage (as defined in subparagraph (5) of this paragraph) for such year.

For purposes of subdivision (i) of this subparagraph, the aggregate fair market value of all assets of the foundation shall include the average of the fair market values on a monthly basis of securities for which market quotations are readily available (within the meaning of subparagraph (4)(i)(*a*) of this paragraph), the average of the foundation's cash balances on a monthly basis (less the cash balances excluded from the computation of the minimum investment return by operation of subparagraph (3)(iv) of this paragraph), and the fair market value of all other assets (except those assets described in subparagraph (2) or (3) of this paragraph) for the period of time during the taxable year for which such assets are held by the foundation. Any determination of the fair market value of an asset required pursuant to the provisions of this subparagraph shall be made in accordance with the rules of subparagraph (4) of this paragraph.

(2) *Certain assets excluded.* For purposes of this paragraph, the assets taken into account in determining minimum investment return shall not include the following:

(i) Any future interest (such as a vested or contingent remainder, whether legal or equitable) of a foundation in the income or corpus of any real or personal property, other than a future interest created by the private foundation after December 31, 1969, until all intervening interests in, and rights to the actual possession or enjoyment of, such property have expired, or, although not actually reduced to the foundation's possession, until such future interest has been constructively received by the foundation, as where it has been credited to the foundation's account, set apart for the foundation, or otherwise made available so that the foundation may acquire it at any time or could have acquired it if notice of intention to acquire had been given;

(ii) The assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for Federal income tax purposes by operation of paragraph (a) of §1.641(b)–3 of this chapter (Income Tax Regulations);

(iii) Any present interest of a foundation in any trust created and funded by another person (see, however, paragraph (b) (2) of this section with respect to amounts received from certain trusts described in section 4947(a) (2));

(iv) Any pledge to the foundation of money or property (whether or not the pledge may be legally enforced); and

(v) Any assets used (or held for use) directly in carrying out the foundation's exempt purpose.

(3) *Assets used (or held for use) in carrying out the exempt purpose*—(i) *In general.* For purposes of subparagraph (2)(v) of this paragraph, an asset is ''used (or held for use) directly in carrying out the foundation's exempt purpose'' only if the asset is actually used by the foundation in the carrying out of the charitable, educational, or other similar purpose which gives rise to the exempt status of the foundation, or if the foundation owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstances of the particular case) and that definite plans exist to commence such use within a reasonable period of time. Consequently, assets which are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not being used (or held for use) directly in carrying out the foundation's exempt purpose, even though the income from such assets is used to carry out such exempt purpose. Whether an asset is held for the production of income or for investment rather than used (or held for use) directly by the foundation to carry out its exempt purpose is a question of fact. For example, an office building used for the purpose of providing offices for employees engaged in the management of endowment funds of the foundation is not being used (or held for use) directly by the foundation to carry out its charitable, educational, or other similar exempt purpose. However, where property is used both for charitable, educational, or other similar exempt purposes and for other purposes, if such exempt use represents 95 percent or more of the total use, such property shall be considered to be used exclusively for a charitable, educational, or other similar exempt purpose. If such exempt use of such property represents less than 95 percent of the total use, reasonable allocation between such exempt and nonexempt use must be made for purposes of this paragraph. Property acquired by the foundation to be used in carrying out its charitable, educational, or other similar exempt purpose may be considered as used (or held for use) directly to carry out such exempt purpose even though the property, in whole or in part, is leased for a limited period of time during which arrangements are made for its conversion to the use for which it was acquired, provided such income-producing use of the property does not exceed a reasonable period of time. Generally, 1 year shall be deemed to be a reasonable period of time for purposes of the immediately preceding sentence. For treatment of the income derived from such income-producing use, see

paragraph (d)(2)(viii) of this section. Where the income-producing use continues beyond a reasonable period of time, the property shall not be deemed to be used by the foundation to carry out its charitable, educational, or other similar exempt purpose, but, instead, as of the time the income-producing use becomes unreasonable, such property shall be treated as disposed of within the meaning of paragraph (d)(2)(iii)(*b*) of this section to the extent that the acquisition of the property was taken into account as a qualifying distribution (within the meaning of paragraph (a)(2) of § 53.4942(a–3) for any taxable year. If, subsequently, the property is used by the foundation directly in carrying out its charitable, educational, or other similar exempt purpose, a qualifying distribution in the amount of its then fair market value, determined in accordance with the rules contained in subparagraph (4) of this paragraph, shall be deemed to have been made as of the time such exempt use begins.

(ii) *Illustrations.* Examples of assets which are ''used (or held for use) directly in carrying out the foundation's exempt purpose'' include, but are not limited to, the following:

(*a*) Administrative assets, such as office equipment and supplies which are used by employees or consultants of the foundation, to the extent such assets are devoted to and used directly in the administration of the foundation's charitable, educational or other similar exempt activities;

(*b*) Real estate or the portion of a building used by the foundation directly in its charitable, educational, or other similar exempt activities;

(*c*) Physical facilities used in such activities, such as paintings or other works of art owned by the foundation which are on public display, fixtures and equipment in classrooms, research facilities and related equipment which under the facts and circumstances serve a useful purpose in the conduct of such activities;

(*d*) Any interest in a functionally related business (as defined in subdivision (iii) of this subparagraph) or in a program-related investment (as defined in section 4944(c));

(*e*) The reasonable cash balances (as described in subdivision (iv) of this subparagraph) necessary to cover current administrative expenses and other normal and current disbursements directly connected with the foundation's charitable, educational, or other similar exempt activities; and

(*f*) Any property leased by a foundation in carrying out its charitable, educational, or other similar exempt purpose at no cost (or at a nominal rent) to the lessee or for a program-related purpose (within the meaning of section 4944(c)), such as the leasing of renovated apartments to low-income tenants at a low rental as part of the lessor foundation's program for rehabilitating a blighted portion of a community. For treatment of the income derived from such use, see paragraph (d)(2)(viii) of this section.

(iii) *Functionally related business—(a) In general.* The term ''functionally related business'' means:

(*1*) A trade or business which is not an unrelated trade or business (as defined in section 513), or

(*2*) An activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the charitable, educational, or other similar exempt purpose of the organization.

(*b*) *Examples.* The provisions of this subdivision may be illustrated by the following examples:

Example 1. X, a private foundation, maintains a community of historic value which is open to the general public. For the convenience of the public, X, through a wholly owned, separately incorporated, taxable entity, maintains a restaurant and hotel in such community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Thus, the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.

Example 2. Y, a private foundation, as part of its medical research program under section 501(c)(3), publishes a medical journal in carrying out its exempt purpose. Space in the journal is sold for commercial advertising. Notwithstanding the fact that the advertising activity may be subject to the tax

imposed by section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the general public developments with respect to medical research and is therefore a functionally related business.

(iv) *Cash held for charitable, etc. activities.* For purposes of subdivision (ii)(*e*) of this subparagraph, the reasonable cash balances which a private foundation needs to have on hand to cover expenses and disbursements described in such subdivision will generally be deemed to be an amount, computed on an annual basis, equal to one and one-half percent of the fair market value of all assets described in subparagraph (1)(i) of this paragraph, without regard to subdivision (ii)(*e*) of this subparagraph. However, if the Commissioner is satisfied that under the facts and circumstances an amount in addition to such one and one-half percent is necessary for payment of such expenses and disbursements, then such additional amount may also be excluded from the amount of assets described in subparagraph (1)(i) of this paragraph. All remaining cash balances, including amounts necessary to pay any tax imposed by section 511 or any section of chapter 42 of the Code except section 4940, are to be included in the assets described in subparagraph (1)(i) of this paragraph.

(4) *Valuation of assets*—(i) *Certain securities.* (*a*) For purposes of subparagraph (1)(i) of this paragraph, a private foundation may use any reasonable method to determine the fair market value on a monthly basis of securities for which market quotations are readily available, as long as such method is consistently used. For purposes of this subparagraph, market quotations are readily available if a security is:

(*1*) Listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange;

(*2*) Regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

(*3*) Locally traded, for which quotations can readily be obtained from established brokerage firms.

(*b*) For purposes of this subdivision, commonly accepted methods of valuation must be used in making an appraisal. Valuations made in accordance with the principles stated in the regulations under section 2031 constitute acceptable methods of valuation. This paragraph (c)(4)(i)(*b*) applies only for taxable years beginning before January 1, 1976. See section 4942(e)(2)(B) and paragraph (c)(4)(i)(*c*) of this section for special valuation rules that apply for subsequent taxable years.

(*c*) For purposes of this subdivision (i) and with respect to taxable years beginning after December 31, 1975, if the private foundation can show that the value of securities determined on the basis of market quotations as provided by subdivision (i)(*a*) does not reflect the fair market value thereof because:

(*1*) The securities constitute a block of securities so large in relation to the volume of actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market.

(*2*) The securities are securities in a closely held corporation and sales are few or of a sporadic nature, and, or

(*3*) The sale of the securities would result in a forced or distress sale because the securities could not be offered to the public for sale without first being registered under the Securities Act of 1933 or because of other factors,

then the price at which the securities could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. On the other hand, if the securities to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to the true value of the securities. No decrease in the fair market value of any given class of securities determined on the basis of market quotations as provided by subdivision (i)(*a*) shall be allowed except as authorized by this subdivision, and no such decrease shall in the aggregate exceed 10 percent of the fair market value of

such class of securities so determined on the basis of market quotations and without regard to this subdivision.

(*d*) In the case of securities described in subdivision (i)(*a*) of this subparagraph, which are held in trust for, or on behalf of, a foundation by a bank or other financial institution which values such securities periodically by use of a computer, a foundation may determine the correct value of such securities by use of such computer pricing system, provided the Commissioner has accepted such computer pricing system as a valid method for valuing securities for Federal estate tax purposes.

(*e*) This subdivision may be illustrated by the following examples:

Example 1. U, a private foundation, owns 1,000 shares of the stock of M Corporation. M stock is regularly traded on the New York Stock Exchange. U consistently follows a practice of valuing its 1,000 shares of M stock on the last trading day of each month based upon the quoted closing price for M stock. U's method of valuing its M Corporation stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

Example 2. Assume the facts as stated in example (1), except that U consistently follows a practice of valuing its 1,000 shares of M stock by taking the mean of the closing prices for M stock on the first and last trading days of each month and the trading day nearest the 15th day of each month. U's method of valuing its M stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

Example 3. Assume the facts as stated in example (1), except that U consistently follows a practice of valuing its M stock by taking the mean of the highest and lowest quoted prices for the stock on the last trading day of each month. U's method of valuing its M stock is permissible under the rules contained in subdivision (1)(*a*) of this subparagraph.

Example 4. V, a private foundation, owns 1,000 shares of the stock of N Corporation. N stock is regularly traded in the national over-the-counter market and published quotations of the bid and asked prices for the stock are available. V consistently follows a practice of valuing its 1,000 shares of N stock on the first trading day of each month by taking the mean of the bid and asked prices on that day. V's method of valuing its N Corporation stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

Example 5. W, a private foundation, owns 1,000 shares of the stock of O Corporation. O stock is locally traded and quotations can readily be obtained from established brokerage firms. W consistently follows a practice of valuing its O stock on the 15th day of each month by obtaining a bona fide quotation of bid and asked prices for the stock from an established brokerage firm and taking the mean of such prices on that day. If a quotation is unavailable on the regular valuation date, W values its O stock based upon a bona fide quotation on the first day thereafter on which such a quotation is available. W's method of valuing its O Corporation stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

(ii) *Cash.* In order to determine the amount of a foundation's cash balances, the foundation shall value its cash on a monthly basis by averaging the amount of cash on hand as of the first day of each month and as of the last day of each month.

(iii) *Common trust funds.* If a private foundation owns a participating interest in a common trust fund (as defined in section 584) established and administered under a plan providing for the periodic valuation of participating interests during the fund's taxable year and the reporting of such valuations to participants, the value of the foundation's interest in the common trust fund based upon the average of the valuations reported to the foundation during its taxable year will ordinarily constitute an acceptable method of valuation.

(iv) *Other assets.* (*a*) Except as otherwise provided in subdivision (iv)(*b*) of this subparagraph, the fair market value of assets other than those described in subdivisions (i) through (iii) of this subparagraph shall be determined annually. Thus, the fair market value of securities other than those described in subdivision (i) of this subparagraph shall be determined in accordance with this subdivision (*a*). If, however, a private foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer (within the meaning of § 53.4943–3(b)(3)(ii), then to the extent that the issuer's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable.

Thus, for example, if a private foundation and a disqualified person together own all of the unlisted voting stock of a holding company which in turn holds a portfolio of securities of issues which are listed on the New York Stock Exchange, in determining the net worth of the holding company, the underlying portfolio securities are to be valued monthly by reference to market quotations for their issues unless a decrease in such value is authorized in accordance with section 4942(e)(2)(b). Such determination may be made by employees of the private foundation or by any other person, without regard to whether such person is a disqualified person with respect to the foundation. A valuation made pursuant to the provisions of this subdivision, if accepted by the Commissioner, shall be valid only for the taxable year for which it is made. A new valuation made in accordance with these provisions is required for the succeeding taxable year.

(*b*) If the requirements of this subdivision are met, the fair market value of any interest in real property, including any improvements thereon, may be determined on a 5-year basis. Such value must be determined by means of a certified, independent appraisal made in writing by a qualified person who is neither a disqualified person with respect to, nor an employee of, the private foundation. The appraisal is certified only if it contains a statement at the end thereof to the effect that, in the opinion of the appraiser, the values placed on the assets appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. The foundation shall retain a copy of the independent appraisal for its records. If a valuation made pursuant to the provisions of this subdivision in fact falls within the range of reasonable values for the appraised property, such valuation may be used by the foundation for the taxable year for which the valuation is made and for each of the succeeding 4 taxable years. Any valuation made pursuant to the provisions of this subdivision may be replaced during the 5-year period by a subsequent 5-year valuation made in accordance with the rules set forth in this subdivision, or with an annual valuation made in accordance with subdivision (iv)(*a*) of this subparagraph, and the most recent such valuation of such assets shall be used in computing the foundation's minimum investment return. In the case of a foundation organized before May 27, 1969, a valuation made in accordance with this subdivision applicable to the foundation's first taxable year beginning after December 31, 1972, and the 4 succeeding taxable years must be made no later than the last day of such first taxable year. In the case of a foundation organized after May 26, 1969, a valuation made in accordance with this subdivision applicable to the foundation's first taxable year beginning after February 5, 1973 and the succeeding 4 taxable years must be made no later than the last day of such first taxable year. Any subsequent valuation made in accordance with this subdivision must be made no later than the last day of the first taxable year for which such new valuation is applicable. A valuation, if properly made in accordance with the rules set forth in this subdivision, will not be disturbed by the Commissioner during the 5-year period for which it applies even if the actual fair market value of such property changes during such period.

(*c*) For purposes of this subdivision, commonly accepted methods of valuation must be used in making an appraisal. Valuations made in accordance with the principles stated in the regulations under section 2031 constitute acceptable methods of valuation. The term *appraisal*, as used in this subdivision, means a determination of fair market value and is not to be construed in a technical sense peculiar to particular property or interests therein, such as, for example, mineral interests in real property.

(v) *Definition of ''securities''*. For purposes of this subparagraph, the term ''securities'' includes, but is not limited to, common and preferred stocks, bonds, and mutual fund shares.

(vi) *Valuation date*. (*a*) In the case of an asset which is required to be valued on an annual basis as provided in subdivision (iv)(*a*) of this subparagraph, such asset may be valued as of any day in the private foundation's taxable

year to which such valuation applies, provided the foundation follows a consistent practice of valuing such asset as of such date in all taxable years.

(*b*) A valuation described in subdivision (iv)(*b*) of this subparagraph may be made as of any day in the first taxable year of the private foundation to which such valuation is to be applied.

(vii) *Assets held for less than a taxable year*. For purposes of this paragraph, any asset described in subparagraph (1)(i) of this paragraph which is held by a foundation for only part of a taxable year shall be taken into account for purposes of determining the foundation's minimum investment return for such taxable year by multiplying the fair market value of such asset (as determined pursuant to this subparagraph) by a fraction, the numerator of which is the number of days in such taxable year that the foundation held such asset and the denominator of which is the number of days in such taxable year.

(5) *Applicable percentage*—(i) *In general*. For purposes of paragraph (c)(1)(ii) of this section, except as provided in paragraph (c)(5)(ii) or (iii) of this section, the applicable percentage is:

(*a*) Six percent for a taxable year beginning in 1970 or 1971;

(*b*) Five and a half percent for a taxable year beginning in 1972;

(*c*) Five and one-quarter percent for a taxable year beginning in 1973;

(*d*) Six percent for a taxable year beginning in 1974 or 1975; and

(*e*) Five percent for taxable years beginning after Dec. 31, 1975.

(ii) *Transitional rule*. In the case of organizations organized before May 27, 1969 (including organizations deemed to be so organized by virtue of the provisions of paragraph (e)(2) of this section), section 4942 shall, for all purposes other than the determination of the minimum investment return under section 4942(j)(3)(B)(ii), for taxable years:

(*a*) Beginning before January 1, 1972, apply without regard to section 4942(e).

(*b*) Beginning in 1972, apply with an applicable percentage of 4⅛ percent,

(*c*) Beginning in 1973, apply with an applicable percentage of 4⅜ percent and

(*d*) Beginning in 1974, apply with an applicable percentage of 5½ percent.

(iii) *Short taxable periods*. In any case in which a taxable year referred to in this subparagraph is a period less than 12 months, the applicable percentage to be applied to the amount determined under the provisions of subparagraph (1) of this paragraph shall be equal to the applicable percentage for the calendar year in which the short taxable period began multiplied by a fraction, the numerator of which is the number of days in such short taxable period and the denominator of which is 365.

(d) *Adjusted net income*—(1) *Definition*. For purposes of paragraph (b) of this section, the term ''adjusted net income'' means the excess (if any) of:

(i) The gross income for the taxable year (including gross income from any unrelated trade or business) determined with the income modifications provided by subparagraph (2) of this paragraph, over

(ii) The sum of the deductions (including deductions directly connected with the carrying on of any unrelated trade or business), determined with the deduction modifications provided by subparagraph (4) of this paragraph, which would be allowed to a corporation subject to the tax imposed by section 11 for the taxable year.

In computing the income includible under this paragraph as gross income and the deductions allowable under this paragraph from such income, the principles of subtitle A of the Code shall apply except to the extent such principles conflict with section 4942 and the regulations thereunder (without regard to this sentence). Except as otherwise provided in this paragraph, no exclusions or deductions from gross income or credits against tax are allowable under this paragraph. For purposes of subdivision (i) of this subparagraph, the term ''gross income'' does not include gifts, grants, or contributions received by the private foundation but does include income from a functionally related business (as defined in paragraph (c)(3)(iii) of this section).

(2) *Income modifications*. The income modifications referred to in subparagraph (1)(i) of this paragraph are as follows:

(i) Section 103 (relating to interest on certain governmental obligations) shall not apply. Hence, interest which would have been excluded from gross income by section 103 shall be included in gross income.

(ii) Capital gains and losses from the sale or other disposition of property shall be taken into account only in an amount equal to any net short-term capital gain (as defined in section 1222(5)) for the taxable year. Long-term capital gain or loss is not included in the computation of adjusted net income. Similarly, net section 1231 gains shall be excluded from the computation of adjusted net income. However, net section 1231 losses shall be included in the computation of adjusted net income, if such losses are otherwise described in subparagraph (1)(ii) of this paragraph. Any net short-term capital loss for a given taxable year shall not be taken into account in computing adjusted net income for such year or in computing net short-term capital gain for purposes of determining adjusted net income for prior or future taxable years regardless of whether the foundation is a corporation or a trust.

(iii) The following amounts shall be included in gross income for the taxable year:

(*a*) Amounts received or accrued as repayments of amounts which were taken into account as a qualifying distribution within the meaning of paragraph (a)(2)(i) of § 53.4942(a)–3 for any taxable year;

(*b*) Notwithstanding subdivision (ii) of this subparagraph, gross amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was taken into account as a qualifying distribution (within the meaning of paragraph (a)(2)(ii) of § 53.4942(a)–3) for any taxable year; and

(*c*) Any amount set aside under paragraph (b) of § 53.4942(a)–3 to the extent it is determined that such amount is not necessary for the purposes for which it was set aside.

(iv) Any distribution received by a private foundation from a disqualified person in redemption of stock held by such private foundation in a business enterprise shall be treated as not essentially equivalent to a dividend under section 302(b)(1) if all of the following conditions are satisfied:

(*a*) Such redemption is of stock which was owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date which are in effect on such date and at all times thereafter);

(*b*) Such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings) applied, in the case of a disposition before January 1, 1975, without taking section 4943(c)(4) into account; and

(*c*) Such foundation receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law).

(v) If, as of the date of distribution of property for purposes described in section 170(c) (1) or (2)(B), the fair market value of such property exceeds its adjusted basis, such excess shall not be deemed an amount includible in gross income.

(vi) The income received by a private foundation from an estate during the period of administration of such estate shall not be included in such foundation's gross income, unless, due to a prolonged period of administration, such estate is considered terminated for Federal income tax purposes by operation of paragraph (a) of § 1.641(b)–3 of this chapter (Income Tax Regulations).

(vii) Distributions received by a private foundation from a trust created and funded by another person shall not be included in the foundation's gross income. However, with respect to distributions from certain trusts described in section 4947(a)(2), see paragraph (b)(2) of this section.

(viii) Gross income shall include all amounts derived from, or in connection with, property held by the foundation, even though the fair market value of such property may not be included in

such foundation's assets for purposes of determining minimum investment return by operation of paragraph (c)(3) of this section.

(ix) Gross income shall include amounts treated in a preceding taxable year as a ''qualifying distribution'' by operation of paragraph (c) of § 53.4942(a)–3 where such amounts are not redistributed by the close of the donee organization's succeeding taxable year in accordance with the rules prescribed in such paragraph (c). In such cases, such amounts shall be included in the donor foundation's gross income for such foundation's first taxable year beginning after the close of the donee organization's first taxable year following the donee organization's taxable year of receipt.

(x) For taxable years ending after October 4, 1976, section 4942(f)(2)(D) states that section 483 (relating to imputed interest on deferred payments) does not apply to payments made pursuant to a binding contract entered into in a taxable year beginning before January 1, 1970. Amounts that are not treated as imputed interest because of section 4942(f)(2)(D) and this subdivision will represent gain or loss from the sale of property. If the gain or loss is long term capital gain or loss, section 4942(f)(2)(B) excludes the gain or loss from the computation of the foundation's gross income. If, in a taxable year beginning after December 31, 1969, there is a substantial change in the terms of a contract entered into in a taxable year beginning before January 1, 1970, then any payment made pursuant to the changed contract is not considered a payment made pursuant to a contract entered into in a taxable year beginning before January 1, 1970. Whether or not a change in the terms of a contract (for example, a change relating to time of payment, sales price, or obligations under the contract) is a substantial change is determined by applying the rules under section 483 and § 1.483–1(b)(4). As used in this subdivision, a binding contract includes an irrevocable written option.

(3) *Adjusted basis*—(i) *In general*. For purposes of subparagraph (2)(ii) of this paragraph, the adjusted basis for purposes of determining gain from the sale or other disposition of property shall be determined in accordance with the rules set forth in subdivision (ii) of this subparagraph and the adjusted basis for purposes of determining loss from such disposition shall be determined in accordance with the rules set forth in subdivision (iii) of this subparagraph. Further, the provisions of this subparagraph do not apply for any purpose other than for purposes of subparagraph (2)(ii) of this paragraph. For example, the determination of gain pursuant to the provisions of section 341 is determined without regard to this subparagraph.

(ii) *Gain from sale or other disposition*. The adjusted basis for purposes of determining gain from the sale or other disposition of property shall be the greater of:

(*a*) The fair market value of such property on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of sale or other disposition under the rules of Part II, Subchapter O, Chapter 1 of the Code, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to such date of sale or other disposition; or

(*b*) The adjusted basis as determined under the rules of Part II, Subchapter O, Chapter 1 of the Code, subject to the provisions of section 4940(c)(3)(B) and the regulations thereunder (and without regard to section 362(c)). With respect to assets acquired prior to December 31, 1969, which were subject to depreciation or depletion, for purposes of determining the adjustments to be made to basis between the date of acquisition and December 31, 1969, and amount equal to straight-line depreciation or cost depletion shall be taken into account. In addition, in determining such adjustments to basis, if any other adjustments would have been made during such period (such as a change in useful life based upon additional data or a change in facts), such adjustments shall also be taken into account.

(iii) *Loss from sale or other disposition*. For purposes of determining loss from the sale or other disposition of property, adjusted basis as determined in subdivision (ii)(*b*) of this subparagraph shall apply.

(iv) *Examples*. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A private foundation, which uses the cash receipts and disbursements method of accounting, purchased certain depreciable real property on December 1, 1969. On December 31, 1969, the fair market value of such property was $100,000 and its adjusted basis (determined under the provisions of this subparagraph) was $102,000. The property was sold on January 2, 1970, for $105,000. Because fair market value on December 31, 1969, $100,000, is less than the adjusted basis as determined by Part II, Subchapter O, Chapter 1 of the Code, $102,000, a short-term gain of $3,000 is recognized (*i.e.*, sale price of $105,000 less the greater of the two possible bases) for purposes of subparagraph (2)(ii) of this paragraph.

Example 2. Assume the facts as stated in example (1), except that the sale price was $95,000. Because the sale price was $7,000 less than the adjusted basis for loss ($102,000 as determined by the application of subdivision (iii) of this subparagraph), there is a capital loss of $7,000 which may be deducted against short-term capital gains for 1970 (if any) in determining net short-term capital gain.

Example 3. A private foundation, which uses the cash receipts and disbursements method of accounting, purchased unimproved land on December 1, 1969. On December 31, 1969, the fair market value of such property was $110,000 and its adjusted basis (determined under the provisions of this subparagraph) was $102,000. The property was sold on January 2, 1970, for $105,000. Since the fair market value on December 31, 1969, $110,000, exceeds the adjusted basis as determined by Part II, Subchapter O, Chapter 1 of the Code, $102,000, such fair market value will be used for purposes of determining gain. However, because the adjusted basis for purposes of determining gain exceeds the sale price, there is no gain. Furthermore, because the adjusted basis for purposes of determining loss, $102,000, is less than sale price, there is no loss.

(4) *Deduction modifications*—(i) *In general*. For purposes of computing adjusted net income under subparagraph (1) of this paragraph, no deduction shall be allowed other than all the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income, except as provided in subdivision (ii) of this subparagraph. Such expenses include that portion of a private foundation's operating expenses which is paid or incurred for the production or collection of gross income. Operating expenses include compensation of officers, other salaries and wages of employees, interest, rent, and taxes. Where only a portion of the property produces (or is held for the production of) income subject to the provisions of section 4942, and the remainder of the property is used for charitable, educational, or other similar exempt purposes, the deductions allowed by this subparagraph shall be apportioned between the exempt and nonexempt uses. Similarly, where the deductions with respect to property used for a charitable, educational, or other similar exempt purpose exceed the income derived from such property, such excess shall not be allowed as a deduction, but may be treated as a qualifying distribution described in paragraph (a)(2)(ii) of § 53.4942(a)–3. Furthermore, this subdivision does not allow deductions which are not paid or incurred for the purposes herein prescribed. Thus, for example, the deductions prescribed by the following sections are not allowable: (*a*) The charitable contributions deduction prescribed under sections 170 and 642(c); (*b*) the net operating loss deduction prescribed under section 172; and (*c*) the special deductions prescribed under Part VIII, Subchapter B, Chapter 1 of the Code.

(ii) *Special rules*. For purposes of computing adjusted net income under subparagraph (1) of this paragraph: (*a*) The allowances for depreciation and depletion as determined under section 4940(c)(3)(B) and the regulations thereunder shall be taken into account, and (*b*) section 265 (relating to expenses and interest relating to tax-exempt interest) shall not apply.

(e) *Certain transitional rules*—(1) *In general*. In the case of organizations organized before May 27, 1969, section 4942 shall:

(i) Not apply to an organization to the extent its income is required to be accumulated pursuant to the mandatory terms (as in effect on May 26, 1969, and at all times thereafter) of an instrument executed before May 27, 1969, with respect to the transfer of income producing property to such organization, except that section 4942 shall

apply to such organization if the organization would have been denied exemption had section 504(a) not been repealed, or would have had its deductions under section 642(c) limited had section 681(c) not been repealed. In applying the preceding sentence, in addition to the limitations contained in section 504(a) or 681(c) before its repeal, section 504(a)(1) or 681(c)(1) shall be treated as not applying to an organization to the extent its income is required to be accumulated pursuant to the mandatory terms (as in effect on January 1, 1951, and at all times thereafter) of an instrument executed before January 1, 1951, with respect to the transfer of income producing property to such organization before such date, if such transfer was irrevocable on such date; and

(ii) Not apply to an organization which is prohibited by its governing instrument or other instrument from distributing capital or corpus to the extent the requirements of section 4942 are inconsistent with such prohibitions.

(2) *Certain existing organizations.* For purposes of this section, an organization will be deemed to be organized prior to May 26, 1969, if it is either a testamentary trust created under the will of an individual who died prior to such date or an inter visos trust which was in existence and irrevocable prior to such date, even though it is not funded until after May 26, 1969. Similarly, a split-interest trust, as described in section 4947(a)(2) (without regard to section 4947(a)(2)(C)), which became irrevocable prior to May 27, 1969, and which is treated as a private foundation under section 4947(a)(1) subsequent to such date, likewise shall be treated as an organization organized prior to such date. See section 507(b)(2) and the regulations thereunder with respect to the applicability of transitional rules where there has been a merger of two or more private foundations or a reorganization of a private foundation.

(3) *Limitation.* With respect to taxable years beginning after December 31, 1971, subparagraph (1) (i) and (ii) of this paragraph shall apply only for taxable years during which there is pending any judicial proceeding by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument (as in effect on May 26, 1969) in order to comply with the provisions of section 4942, and in the case of subparagraph (1)(i) of this paragraph for all taxable years following the taxable year in which such judicial proceeding is terminated during which the governing instrument or any other instrument does not permit compliance with such provisions. Thus, the exception described in subparagraph (1)(ii) of this paragraph applies after 1971 only for taxable years during which such judicial proceeding is pending. Accordingly, beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, such foundation will be required to meet the requirements of section 4942 and the regulations thereunder (and be subject to the taxes provided upon failure to do so) except to the extent such foundation is required to accumulate income as described in subparagraph (1)(i) of this paragraph, even if the governing instrument continues to prohibit invasion of capital or corpus. In any case where a foundation's governing instrument or any other instrument requires accumulation of income as described in subparagraph (1)(i) of this paragraph beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, the distributable amount (as defined in paragraph (b) of this section) for such foundation shall be reduced by the amount of the income required to be accumulated. Therefore, if the foundation's adjusted net income for any taxable year equals or exceeds its minimum investment return for such year, the accumulation provisions will be given full effect. However, if the minimum investment return exceeds the adjusted net income for any taxable year, the foundation will be required to distribute such excess for such year. For purposes of this paragraph, a judicial proceeding will be treated as pending only if the foundation is diligently pursuing its judicial remedies and there is no unreasonable delay in such proceeding for which the private foundation is responsible.

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

Example 1. X, a private foundation organized in 1930, is required by the mandatory terms of its governing instrument to accumulated 25 percent of its adjusted net income and to add such accumulations to corpus. The instrument also prohibits distribution of corpus for any purpose. On July 13, 1971, X instituted an action in the appropriate State court to reform the instrument by deleting the accumulation and corpus provisions described above. If the court's final order reforms the accumulation provisions to allow distributions of income sufficient to avoid the imposition of a tax under section 4942, then section 4942 applies to X, regardless of the court's action with respect to the corpus provisions. However, if the court rules that the accumulation provision may not be reformed, section 4942 applies to X only to the extent provided for in subparagraph (3) of this paragraph, regardless of the court's action with respect to the corpus provision.

Example 2. Private foundation Y was created by the will of A who died in 1940. Y's governing instrument requires that 40 percent of Y's adjusted net income be added to corpus each year. In an action commenced prior to December 31, 1971, a court of competent jurisdiction rules that this accumulation provisions must be complied with. In Y's succeeding taxable year its adjusted net income is $120,000, and its minimum investment return is $140,000. Thus, Y is required to accumulated $48,000 (40 percent of $120,000) and shall be allowed to do so. Therefore, Y's distributable amount for such taxable year shall be the greater of its adjusted net income ($120,000) or its minimum investment return ($140,000), reduced by the amount of the income required to be accumulated ($48,000) and the taxes imposed by Subtitle A of the Code and section 4940 and increased by any trust distributions described in paragraph (b)(2) of this section. Accordingly, Y's distributable amount for such taxable year is $92,000 ($140,000 reduced by $48,000), before other adjustments. If Y's minimum investment return had been $120,000 instead of $140,000, its distributable amount for such taxable year would have been $72,000 ($120,000 reduced by $48,000), before other adjustments. Similarly, if Y's minimum investment return had been $100,000 instead of $140,000, its distributable amount for such taxable year would also have been $72,000, before other adjustments.

[T.D. 7256, 38 FR 3317, Feb. 5, 1973; 38 FR 4577, Feb. 16, 1973, as amended by T.D. 7486, 42 FR 24265, May 13, 1977; TD 7594, 44 FR 7138, Feb. 6, 1979; T.D. 7610, 44 FR 21644, Apr. 11, 1979; T.D. 7715, 45 FR 56803, Aug. 26, 1980; T.D. 7849, 47 FR 50857, Nov. 10, 1982; T.D. 7878, 48 FR 11943, Mar. 22, 1983]

§ 53.4942(a)–3 Qualifying distributions defined.

(a) *In general*—(1) *Distributions generally.* For purposes of section 4942 and the regulations thereunder, the amount of a qualifying distribution of property (as defined in subparagraph (2) of this paragraph) is the fair market value of such property as of the date such qualifying distribution is made. The amount of an organization's qualifying distributions will be determined solely on the cash receipts and disbursements method of accounting described in section 446(c)(1).

(2) *Definition.* The term *qualifying distribution* means:

(i) Any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c) (1) or (2)(B), other than any contribution to:

(*a*) A private foundation which is not an operating foundation (as defined in section 4942(j)(3)), except as provided in paragraph (c) of this section, or

(*b*) An organization controlled (directly or indirectly) by the contributing private foundation or one or more disqualified persons with respect to such foundation, except as provided in paragraph (c) of this section;

(ii) Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c) (1) or (2)(B). See paragraph (c)(3) of § 53.4942(a)–2 for the definition of *used (or held for use)*; or

(iii) Any amount set aside within the meaning of paragraph (b) of this section.

(3) *Control.* For purposes of subparagraph (2)(i)(*b*) of this paragraph, an organization is ''controlled'' by a foundation or one or more disqualified persons with respect to the foundation if

any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure, regardless of the method by which the control is exercised or exercisable. ''Control'' of a donee organization is determined without regard to any conditions imposed upon the donee as part of the distribution or any other restrictions accompanying the distribution as to the manner in which the distribution is to be used, unless such conditions or restrictions are described in paragraph (a)(8) of §1.507–2 of this chapter (Income Tax Regulations). In general, it is the donee, not the distribution, which must be ''controlled'' by the distributing private foundation for the provisions of subparagraph (2)(i)(*b*) of this paragraph to apply. Thus, the furnishing of support to an organization and the consequent imposition of budgetary procedures upon that organization with respect to such support shall not in itself be treated as subjecting that organization to the distributing foundation's control within the meaning of this subparagraph. Such ''budgetary procedures'' include expenditure responsibility requirements under section 4945(d)(4). The ''controlled'' organization need not be a private foundation; it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.

(4) *Borrowed funds*—(i) *In general*. For purposes of this paragraph, if a private foundation borrows money in a particular taxable year to make expenditures for a specific charitable educational, or other similar purpose, a qualifying distribution out of such borrowed funds will, except as otherwise provided in subdivision (ii) of this subparagraph, be deemed to have been made only at the time that such borrowed funds are actually distributed for such exempt purpose.

(ii) *Funds borrowed before 1970*. (*a*) If a private foundation has borrowed money in a taxable year beginning before January 1, 1970, or subsequently borrows money pursuant to a written commitment which was binding as of the last day of such taxable year, to make expenditures for a specific charitable, educational, or other similar exempt purpose, if such borrowed funds are in fact expended for such purpose in any taxable year, and if such loan is thereafter repaid, in whole or in part, in a taxable year beginning after December 31, 1969, then, at the election of the foundation as provided in subdivision (ii)(*b*) of this subparagraph, a qualifying distribution will be deemed to have been made at such time or times that such loan principal is so repaid rather than at the earlier time that the borrowed funds were actually distributed for such exempt purpose.

(*b*) The election described in subdivision (ii)(*a*) of this subparagraph is to be made by attaching a statement to the form the private foundation is required to file under section 6033 for the first taxable year beginning after December 31, 1969, in which a repayment of loan principal is made. Such statement shall be made a part of such form and shall be attached to such form in each succeeding taxable year in which any repayment of loan principal is made. The statement shall set forth the name and address of the lender, the amount borrowed, the specific use made of such borrowed funds, and the private foundation's election to treat repayments of loan principal as qualifying distributions.

(iii) *Interest*. Any payment of interest with respect to a loan described in subdivision (i) or (ii) of this subparagraph shall be treated as a deduction under paragraph (d)(1)(ii) of §53.4942(a)–2 in the taxable year in which it is made.

(5) *Changes in use of an asset*. If an asset not used (or held for use) directly in carrying out one or more purposes described in section 170(c) (1) or (2)(B) is subsequently converted to such a use, the foundation may treat such conversion as a qualifying distribution. The amount of such qualifying distribution shall be the fair market value of the converted asset as of the date of its conversion. For purposes of the preceding sentence, fair market value shall be determined by making a valuation of the converted asset as of the date of its conversion in accordance with the rules set forth in paragraph (c)(4) of §53.4942(a)-2.

(6) *Certain foreign organizations*—(i) *In general*. Distributions for purposes described in section 170(c)(2)(B) to a foreign organization, which has not received a ruling or determination letter that it is an organization described in section 509(a) (1), (2), or (3) or 4942(j)(3), will be treated as a distribution made to an organization described in section 509(a) (1), (2), or (3) or 4942(j)(3) if the distributing foundation has made a good faith determination that the donee organization is an organization described in section 509(a) (1), (2), or (3) or 4942(j)(3). Such a ''good faith determination'' ordinarily will be considered as made where the determination is based on an affidavit of the donee organization or an opinion of counsel (of the distributing foundation or the donee organization) that the donee is an organization described in section 509(a) (1), (2), or (3) or 4942(j)(3). Such an affidavit or opinion must set forth sufficient facts concerning the operations and support of the donee organization for the Internal Revenue Service to determine that the donee organization would be likely to qualify as an organization described in section 509(a) (1), (2), or (3) or 4942(j)(3).

(ii) *Definition*. For purposes of this subparagraph, the term *foreign organization* means any organization which is not described in section 170(c)(2)(A).

(7) *Payment of tax*. The payment of any tax imposed under chapter 42 of the Code shall not be treated as a qualifying distribution.

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

Example 1. M, a private foundation which uses the calendar year as the taxable year, makes the following payments in 1970: (i) a payment of $44,000 to five employees for conducting a foundation program of educational grants for research and study; (ii) $20,000 for various items of overhead, 10 percent of which is attributable to the activities of the employees mentioned in payment (i) of this example and the other 90 percent of which is attributable to administrative expenses which were not paid to accomplish any section 170(c) (1) or (2)(B) purpose; and (iii) a $100,000 general purpose grant paid to an educational institution described in section 170(b)(1)(A)(ii) which is not controlled by M or any disqualified persons with respect to M. Payments (i) and (ii) of this example are qualifying distributions to the extent of $46,000 ($44,000 of salaries and 10 percent of the overhead, both of which are reasonable administrative expenses paid to accomplish section 170(c) (1) or (2)(B) purposes). Payment (iii) of this example is also a qualifying distribution, since it is a contribution for section 170(c)(2)(B) purposes to an organization which is not described in subparagraph (2)(i) (*a*) or (*b*) of this paragraph. The other 90 percent of payment (ii) of this example may constitute items of deduction under paragraph (d)(1)(ii) of § 53.4942(a)–2 if such items otherwise qualify under such paragraph.

Example 2. On February 21, 1972, N, a private foundation which uses the calendar year as the taxable year, pays $500,000 for real property on which it plans to build hospital facilities to be used for medical care and education. The real property produces no income and the hospital facilities will not be constructed until 1974 according to the set-aside plan submitted to and approved by the Commissioner pursuant to paragraph (b) of this section. The purchase of the land is a qualifying distribution under subparagraph (2)(ii) of this paragraph. If, however, the property used were to produce rental income for more than a reasonable period of time before construction of the hospital is begun, then as of the time such rental use becomes unreasonable (i) such purchase would no longer constitute a qualifying distribution under subparagraph (2)(ii) of this paragraph, and (ii) the amount of the qualifying distribution would be included in N's gross income. See paragraphs (c)(3)(i) and (d)(2)(iii)(*b*) of § 53.4942(a)–2.

Example 3. In 1971, X, a private foundation engaged in holding paintings and exhibiting them to the public, purchases an additional building to be used to exhibit the paintings. Such expenditure is a qualifying distribution under subparagraph (2)(ii) of this paragraph. In 1975, X sells the building. Under paragraph (d)(2)(iii)(*b*) of § 53.4942(a)–2, all of the proceeds of the sale (less direct costs of the sale) are included in X's adjusted net income for 1975.

Example 4. In January 1969, M, a private foundation which uses the calendar year as the taxable year, borrows $10 million to give to N, a private college, for the construction of a science center. M borrowed the money from X, a commercial bank. M is to repay X at the rate of $1.1 million per year ($1 million principal and $0.1 million interest) for 10 years, beginning in January, 1973. M distributed $5 million of the borrowed funds to N in February 1969 and the other $5 million in March 1970. M files a statement with the form it is required to file under section 6033 for 1973 which contains the information required by subparagraph (4)(ii)(*b*) of this paragraph. Pursuant to M's election, each repayment of loan principal constitutes a qualifying distribution in the year of repayment. Accordingly, the distribution of $5 million to

N in March 1970 will not be treated as a qualifying distribution. Each payment of interest ($0.1 million annually) with respect to M's loan from X is treated as a deduction under paragraph (d)(1)(ii) of § 53.4942(a)–2 in the taxable year in which it is made.

Example 5. Private foundation Y engages in providing care for the aged. Y makes a distribution of cash to H, a hospital described in section 170(b)(1)(A)(iii) which is not controlled by Y or any disqualified person with respect to Y. The distribution is made subject to the conditions that H will invest the money as a separate fund which will bear a name commemorating the creator of Y and will use the income from such fund only for H's exempt hospital purposes which relate to care for the aged. Under these circumstances, the distribution from Y to H is a qualifying distribution pursuant to subparagraph (2)(i) of this paragraph.

(b) *Certain set-asides*—(1) *In general.* An amount set aside for a specific project that is for one or more of the purposes described in section 170(c) (1) or (2)(B) may be treated as a qualifying distribution in the year in which set aside (but not in the year in which actually paid), if the requirements of section 4942(g)(2) and this paragraph (b) are satisfied. The requirements of this paragraph (b) are satisfied if the private foundation establishes to the satisfaction of the Commissioner that the amount set aside will be paid for the specific project within 60 months after it is set aside, and

(i) The set-aside satisfies the suitability test described in subparagraph (2) of this paragraph, or

(ii) With respect to a set-aside made in a taxable year beginning after December 31, 1974, the private foundation satisfies the cash distribution test described in subparagraph (3) of this paragraph.

If the suitability test or cash distribution test is otherwise satisfied, the 60 month period for paying the amount set aside may, for good cause shown, be extended by the Commissioner.

(2) *Suitability test.* The suitability test is satisfied if the private foundation establishes to the satisfaction of the Commissioner that the specific project for which the amount is set aside is one that can be better accomplished by the set-aside than by the immediate payment of funds. Specific projects that can be better accomplished by the use of a set-aside include, but are not limited to, projects in which relatively long-term grants or expenditures must be made in order to assure the continuity of particular charitable projects or program-related investments (as defined in section 4944(c)) or where grants are made as part of a matching-grant program. Such projects include, for example, a plan to erect a building to house the direct charitable, educational, or other similar exempt activity of the private foundation (such as a museum building in which paintings are to be hung), even though the exact location and architectural plans have not been finalized; a plan to purchase an additional group of paintings offered for sale only as a unit that requires an expenditure of more than one year's income; or a plan to fund a specific research program that is of such magnitude as to require an accumulation of funds before beginning the research, even though not all of the details of the program have been finalized.

(3) *Cash distribution test; in general.* The cash distribution test is satisfied if:

(i) The specific project for which the amount is set aside will not be completed before the end of the taxable year in which the set-aside is made,

(ii) The private foundation actually distributes, in cash or its equivalent and for one or more of the purposes described in section 170(c) (1) or (2)(B), the ''start-up period minimum amount'' described in subparagraph (4) of this paragraph during the private foundation's start-up period, and

(iii) The private foundation actually distributes, in cash or its equivalent and for one or more of the purposes described in section 170(c) (1) or (2)(B), the ''full-payment period minimum amount'' described in subparagraph (5) of this paragraph in each taxable year of the private foundation's full-payment period.

For purposes of the cash distribution test, an amount set aside will be treated as distributed in the year in which actually paid and not in the year in which set aside.

(4) *Minimum distribution required during start-up period*—(i) *Start-up period.* For private foundations created before January 1, 1972, the start-up period is

the four taxable years immediately preceding the taxable year beginning in calendar year 1976. For private foundations created after December 31, 1971 (or for organizations that first become private foundations after that date), the start-up period is the four taxable years following the taxable year in which the private foundation was created (or otherwise became a private foundation). For purposes of this subparagraph (4), a private foundation will be considered ''created'' in the taxable year in which the private foundation's distributable amount (as determined under section 4942(d)) first exceeds $500.

(ii) *Start-up period minimum amount.* The amount that a private foundation must actually distribute in cash or its equivalent during the private foundation's start-up period is not less than the sum of:

(*a*) Twenty percent of the private foundation's distributable amount (as determined under section 4942(d)) for the first taxable year of the start-up period,

(*b*) Forty percent of the private foundation's distributable amount for the second taxable year of the start-up period,

(*c*) Sixty percent of the private foundation's distributable amount for the third taxable year of the start-up period, and

(*d*) Eighty percent of the private foundation's distributable amount for the fourth taxable year of the start-up period.

(iii) *Timing of distributions.* The requirement that a private foundation distribute the start-up period minimum amount during the start-up period is a requirement that such amount be distributed before the end of the start-up period, and is not a requirement that any portion of such amount be distributed in any one taxable year of the start-up period.

(iv) *Distribution actually made during start-up period.* In general, only a distribution actually made during the start-up period is taken into account in determining whether a private foundation has distributed the start-up period minimum amount. However, in the case of a private foundation created after December 31, 1971 (or an organization that first became a private foundation after that date), a distribution actually made during the taxable year in which the foundation was created (the year immediately preceding the first taxable year of the private foundation's start-up period) may be treated as a distribution actually made during the start-up period. In addition, a distribution actually made by a private foundation within 5½ months after the end of the start-up period will be treated as a distribution actually made during the start-up period if:

(*a*) The private foundation was unable to determine the distributable amount for the fourth taxable year of the start-up period until after the end of such period, and

(*b*) The private foundation actually made distributions prior to the end of the start-up period based upon a reasonable estimate of the private foundation's distributable amount for the fourth taxable year of the start-up period.

(v) *Examples.* The provisions of this subparagraph (4) may be illustrated by the following examples:

Example 1. F, a private foundation created on January 1, 1975, uses the calendar year as its taxable year. The start-up period for F is January 1, 1976 through December 31, 1979. F has distributable amounts under section 4942(d) for taxable years 1976 through 1979 in the following amounts: 1976, $100,000; 1977, $120,000; 1978, $150,000; 1979, $200,000. F's start-up period minimum amount is the sum of the following amounts: 20% of $100,000 ($20,000); 40% of $120,000 ($48,000); 60% of $150,000 ($90,000); and 80% of $200,000 ($160,000); which equals $318,000. Thus F is required to actually distribute at least $318,000 in cash or its equivalent during the start-up period.

Example 2. F, a private foundation created in 1969, uses the calendar year as its taxable year. F's start-up period is the calendar years 1972 through 1975. F makes two cash distributions in 1972. The first distribution is made on account of a set-aside made in 1969. Under section 4942(g), that distribution is treated as a qualifying distribution made in 1969. The second distribution is treated under section 4942(h) has made out of F's undistributed income for 1971. In addition, F makes a cash distribution in 1976 that is treated under section 4942(h) as made out of F's undistributed income for 1975. In determining whether F has distributed its start-up period minimum amount within the start-up period, the 1972 distributions are both taken into account because they were actually made during F's start-up period. The 1976 distribution is not taken into account, however, because

that distribution was not actually made during F's start-up period.

(5) *Minimum distribution required during full-payment period*—(i) *Full-payment period*. A private foundation's full-payment period includes each taxable year that begins after the end of the private foundation's start-up period.

(ii) *Full-payment period minimum amount*. The amount that a private foundation must actually distribute in cash or its equivalent in a taxable year of the private foundation's full-payment period is not less than 100 percent of the private foundation's distributable amount determined under section 4942(d) (without regard to section 4942(i)) with respect to the taxable year.

(iii) *Carryover of distributions in excess of full-payment period minimum amount*. If, in a taxable year beginning after December 31, 1975, a private foundation distributes an amount in excess of the full-payment period minimum amount for the taxable year, the excess shall be used to reduce the full-payment period minimum amount in the taxable years in the adjustment period. The amount of the excess distribution used to reduce the full-payment period minimum amount in each successive taxable year of the adjustment period shall be equal to the amount of such excess less the sum of the full-payment period minimum amounts for all prior taxable years in the adjustment period to which the excess was previously applied. The taxable years in the adjustment period are the five taxable years immediately following the taxable year in which the excess distribution is made. Any distribution in excess of the full-payment period minimum amount made during a taxable year of the adjustment period shall not be taken into account under this subparagraph (iii) until any earlier excess has been completely applied against full-payment period minimum amounts during its adjustment period.

(iv) *Distributions actually made during a taxable year*. Except as described in subdivision (ii) of subparagraph (6), only a distribution actually made during a taxable year of the full-payment period is taken into account in determining whether a private foundation has distributed the full-payment period minimum amount for such year.

(v) *Examples*. The provisions of this subparagraph (5) may be illustrated by the following examples:

Example 1. F, a private foundation created on January 1, 1973, uses the calendar year as its taxable year. F has a start-up period of January 1, 1974, through December 31, 1977, and a full-payment period that includes every taxable year beginning after December 31, 1977. F's distributable amount (as determined under section 4942(d)) for 1978 is $500,000. Thus, F's full-payment period minimum amount for 1978 is $500,000. During 1978 F distributes $100,000 in cash to Charity X and $400,000 in cash to Charity Y on account of a set-aside made in 1973. F has distributed its full-payment period minimum amount for 1978 because it has made actual cash distributions during that year which total $500,000. However, F has made qualifying distributions (as determined under section 4942(g)) with respect to 1978 of only $100,000. In order to avoid liability for the tax on undistributed income under section 4942(a), F must distribute or set aside an additional $400,000 before January 1, 1980.

Example 2. Assume the facts as stated in Example (1) except that in 1978 F makes cash distributions totaling $600,000. Since the total cash distributions made in 1978 ($600,000) exceed the full-payment period minimum amount for 1978 ($500,000), there exists a $100,000 excess which must be used by F to reduce its full-payment period minimum amounts for the years 1979–1983 (the taxable years in the adjustment period with respect to the 1978 excess). Therefore, if F's distributable amount (as determined under section 4942(d)) for 1979 is $500,000, F's full-payment period minimum amount for 1979 is $400,000 ($500,000–$100,000).

(6) *Failure to distribute minimum amounts*—(i) *In general*. If a private foundation fails to actually distribute the start-up period minimum amount during the start-up period or, except as described in subdivision (ii) of this subparagraph (6), if a private foundation fails to actually distribute the full-payment period minimum amount during a taxable year of the full-payment period, then any set-aside made by the private foundation during the start-up period (if the failure relates to the start-up period) or during the taxable year (if the failure relates to the full-payment period) that was not approved by the Commissioner under the suitability test described in subparagraph (2) of this paragraph will not be treated

as a qualifying distribution. Further, any set-aside made after the year of such a failure to so distribute a minimum amount will be treated as a qualifying distribution only if the Commissioner approves the set-aside under the suitability test. In any case in which a set-aside ceases to be treated as a qualifying distribution as a result of a failure to distribute the full-payment period minimum amount, a private foundation may be assessed a deficiency under section 4942(a) within the period described in section 6501(n)(3).

(ii) *Correction of certain failures to distribute.* If a private foundation's failure to distribute the full-payment period minimum amount during a taxable year of the full-payment period was not willful and was due to reasonable cause, the private foundation may correct the failure to so distribute. Correction will be achieved if the private foundation distributes within the correction period cash or its equivalent in an amount not less than the difference between the full-payment period minimum amount for the taxable year and the amount actually distributed during the taxable year. The correction period is the correction period as defined in section 4962(e), determined with respect to the earliest occurring taxable event (as defined in section 4962(e)(2)(A)) that would result if the failure to distribute a full-payment period minimum amount were not corrected. The additional distribution will be treated for purposes of subparagraph (5) of this paragraph as made during the taxable year with respect to which the failure occurred. If a private foundation fails to distribute the full-payment period minimum amount during a taxable year of the full-payment period because such amount can be determined only after the end of the taxable year, no ''willful failure to distribute'' the full-payment period minimum amount will occur if the private foundation makes an additional distribution within 5½ months after the end of the taxable year.

(7) *Approval and information requirements*—(i) *Suitability test.* If an amount is set aside under the suitability test of section 4942(g)(2)(B)(i) and subparagraph (2) of this paragraph, the private foundation must apply for the Commissioner's approval of the set-aside before the end of the taxable year in which the amount is set aside. The Commissioner will either approve or disapprove the set-aside in writing. An otherwise proper set-aside will not be treated as a qualifying distribution under this paragraph (b) with respect to a taxable year if the Commissioner's approval is not sought before the end of the taxable year in which the amount is actually set aside. To obtain approval by the Commissioner for a set-aside under the suitability test, the private foundation must write to Commissioner of Internal Revenue, Attention: OP:E:EO:T, 1111 Constitution Avenue, NW., Washington, DC 20224, and include:

(*a*) A statement describing the nature and purposes of the specific project and the amount of the set-aside for which approval is requested;

(*b*) A statement describing the amounts and approximate dates of any planned additions to the set-aside after its initial establishment;

(*c*) A statement of the reasons why the project can be better accomplished by a set-aside than by the immediate payment of funds;

(*d*) A detailed description of the project, including estimated costs, sources of any future funds expected to be used for completion of the project, and the location or locations (general or specific) of any physical facilities to be acquired or constructed as part of the project; and

(*e*) A statement by an appropriate foundation manager (as defined in section 4946(b)) that the amounts to be set aside will actually be paid for the specific project within a specified period of time that ends not more than 60 months after the date of the first set-aside, or a statement showing good cause why the period for paying the amount set aside should be extended (including a showing that the proposed project could not be divided into two or more projects covering periods of no more than 60 months each) and setting forth the extension of time required.

(ii) *Cash distribution test.* If an amount is set aside under the cash distribution test of section 4942(g)(2)(B)(ii) and subparagraphs (3), (4), and (5) of this paragraph, then for taxable years

ending after April 2, 1984, the private foundation must submit an attachment with the return required by section 6033 for the taxable year in which the amount is set aside and for certain subsequent taxable years. For the taxable year in which the amount is set aside the attachment must include:

(*a*) A statement describing the nature and purposes of the specific project for which amounts are to be set aside;

(*b*) A statement that the amounts set aside for the specific project will actually be paid for the specific project within a specified period of time that ends not more than 60 months after the date of the set-aside;

(*c*) A statement that the project will not be completed before the end of the taxable year of the private foundation in which the set-aside is made;

(*d*) A statement showing the distributable amounts determined under section 4942(d) for any past taxable years in the private foundation's start-up and full-payment periods; and

(*e*) A statement showing the aggregate amount of actual payments made in cash or its equivalent, for purposes described in section 170(c) (1) or (2)(B), during each taxable year in the private foundation's start-up and full-payment periods. This statement should include a detailed description of any payments that are to be treated, pursuant to the rules of subparagraphs (4)(iv) and (6)(ii) of this paragraph (b), as distributed during a taxable year prior to the taxable year in which such payments were actually made and, in addition, should explain the circumstances that justify the application of those rules.

For the five taxable years following the taxable year in which the amount is set aside (or, if longer, for each taxable year in the extended period for paying the amount set aside), the attachment must include the statements required by (*d*) and (*e*) of this subdivision (ii). The submission of the statement required by (*b*) of this subdivision (ii) will satisfy the requirement of section 4942(g)(2)(B) and subparagraph (1) of this paragraph (b) that the private foundation establish to the satisfaction of the Commissioner that the amount set aside will be paid for the specific project within 60 months after it is set aside.

(8) *Evidence of set-aside.* A set-aside that is approved by the Commissioner or which satisfies the cash distribution test shall be evidenced by the entry of a dollar amount on the books and records of a private foundation as a pledge or obligation to be paid at a future date or dates. Any amount which is set aside shall be taken into account for purposes of determining the private foundation's minimum investment return under §53.4942(a)–2 (c)(1), and any income attributable to such set-aside shall be taken into account in computing adjusted net income under §53.4942(a)–2(d).

(9) *Contingent set-aside.* In the event a private foundation is involved in litigation and may not distribute assets or income because of a court order, the private foundation may (except as provided in §53.4942(a)–2 (e)(1)(i) or (ii)) seek and obtain a set-aside for a purpose described in §53.4942(a)–3 (a)(2). The amount to be set aside shall be equal to that portion of the private foundation's distributable amount which is attributable to the assets or income that are held pursuant to court order and which, but for the court order precluding the distribution of such assets or income, would have been distributed. In the event that the litigation encompasses more than one taxable year, the private foundation may seek additional contingent set-asides. Such amounts must actually be distributed by the last day of the taxable year following the taxable year in which the litigation is terminated. Amounts not distributed by the close of the appropriate taxable year shall be treated as described in §53.4942(a)–2 (d)(2)(iii)(*c*) for the succeeding taxable year.

(c) *Certain contributions to section 501(c)(3) organizations*—(1) *In general.* For purposes of this section, the term ''qualifying distribution'' includes (in the year in which it is paid) a contribution to an exempt organization described in section 501(c)(3) and described in paragraph (a)(2)(i) (*a*) or (*b*) of this section if:

(i) Not later than the close of the first taxable year after the donee organization's taxable year in which such contribution is received, such donee organization makes a distribution equal

to the full amount of such contribution and such distribution is a qualifying distribution (within the meaning of paragraph (a) of this section, without regard to this paragraph) which is treated under paragraph (d) of this section as a distribution out of corpus (or would be so treated if such section 501(c)(3) organization were a private foundation which is not an operating foundation); and

(ii) The private foundation making the contribution obtains adequate records or other sufficient evidence from such donee organization (such as a statement by an appropriate officer, director, or trustee of such donee organization) showing (except as otherwise provided in this subparagraph) (*a*) that the qualifying distribution described in subdivision (i) of this subparagraph has been made by such organization, (*b*) the names and addresses of the recipients of such distribution and the amount received by each, and (*c*) that the distribution is treated as a distribution out of corpus under paragraph (d) of this section (or would be so treated if the donee organization were a private foundation which is not an operating foundation). Where a distribution is for an administrative expense which is part of a section 170(c) (1) or (2)(B) expenditure or is part of another section 170(c) (1) or (2)(B) expenditure that cannot reasonably be separately accounted for, the provisions of subdivision (ii) of this subparagraph may be satisfied by the submission by the donee organization of a statement setting forth the general purpose for which such expenditure was made and that the amount was distributed as a qualifying distribution described in subdivision (ii)(*c*) of this subparagraph.

(2) *Distribution requirements.* (i) In order for a donee organization to meet the distribution requirements of subparagraph (1)(i) of this paragraph, it must, not later than the close of the first taxable year after its taxable year in which any contributions are received, distribute (within the meaning of this subparagraph) an amount equal in value to the contributions received in such prior taxable year and have no remaining undistributed income for such prior taxable year. In the event that a donee organization redistributes less than an amount equal to the total contributions from donor organizations which are required to be redistributed by such donee organization by the close of the first taxable year following the taxable year in which such contributions were received, amounts treated as redistributions of such contributions shall be deemed to have been made pro rata out of all such contributions regardless of any earmarking or identification made by such donee organization with respect to the source of such distributions. See paragraph (d)(2)(ix) of § 53.4942(a)–2 for the treatment of amounts deemed not to have been so redistributed. For purposes of this paragraph, the term *contributions* means all contributions, whether of cash or property, and the fair market value of contributed property determined as of the date of the contribution must be used in determining whether an amount equal in value to the contributions received has been redistributed.

(ii) For purposes of this paragraph, the characterization of qualifying distributions made during the taxable year (*i.e.*, whether out of the prior year's undistributed income, the current year's undistributed income, or corpus) is to be made as of the close of the taxable year in question, except to the extent that a different characterization is effected by means of the election provided for by paragraph (d)(2) of this section or by subdivision (iv) of this subparagraph. Once it is determined that a qualifying distribution is attributable to corpus, such distribution will first be charged to distributions which are required to be redistributed under this paragraph.

(iii) All amounts contributed to a specific exempt organization described in section 501(c)(3) and in paragraph (a)(2)(i) (*a*) or (*b*) of this section within any one taxable year of such organization shall be treated (with respect to the contributing private foundation) as one ''contribution''. If subparagraph (1)(i) or (ii) of this paragraph is not completely satisfied with respect to such contribution within the meaning of such subparagraph, only that portion

of such contribution which was redistributed (within the meaning of subparagraph (1) (i) and (ii) of this paragraph) shall be treated as a qualifying distribution.

(iv) In order to satisfy distribution requirements under section 170(b)(1)(E)(ii) or this paragraph, a donee organization may elect to treat as a current distribution out of corpus any amount distributed in a prior taxable year which was treated as a distribution out of corpus under paragraph (d)(1)(iii) of this section provided that (*a*) such amount has not been availed of for any other purpose, such as a carryover under paragraph (e) of this section or a redistribution under this paragraph for a prior year, (*b*) such corpus distribution occurred within the preceding 5 years, and (*c*) such amount is not later availed of for any other purpose. Such election must be made by attaching a statement to the return the foundation is required to file under section 6033 with respect to the taxable year for which such election is to apply. Such statement must contain a declaration by an appropriate foundation manager (within the meaning of section 4946(b)(1)) that the foundation is making an election under this paragraph and it must specify that the distribution was treated under paragraph (d)(1)(iii) of this section as a distribution out of corpus in a designated prior taxable year (or years).

(3) *Examples*. The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples. It is assumed in these examples that all private foundations described use the calendar as the taxable year.

Example 1. In 1972 M, a private foundation, makes a contribution out of 1971 income to X, another private foundation which is not an operating foundation. The contribution is the only one received by X in 1972. In 1973 X makes a qualifying distribution to an art museum maintained by an operating foundation in an amount equal to the amount of the contribution received from M. X also distributes all of its undistributed income for 1972 and 1973 for other purposes described in section 170(c)(2)(B). Under the provisions of paragraph (d) of this section, such distribution to the museum is treated as a distribution out of corpus. Thus, M's contribution to X is a qualifying distribution out of M's 1971 income provided M obtains adequate records or other sufficient evidence from X showing the nature and amount of the distribution made by X, the identity of the recipient, and the fact that the distribution is treated as made out of corpus. If X's qualifying distributions during 1973 had been equal only to M's contribution to X and X's undistributed income for 1972, X could have made an election under paragraph (d)(2) of this section to treat the amount distributed in excess of its 1972 undistributed income as a distribution out of corpus and in that manner satisfied the requirements of this paragraph.

Example 2. Assume the facts stated in example (1), except that X is a private college described in section 170(b)(1)(A)(ii) which is controlled by disqualified persons with respect to M and that the records which X furnishes to M show that the distribution would have been treated as made out of corpus if X were a private nonoperating foundation. Under these circumstances, result is the same as in example (1).

Example 3. Assume the facts stated in example (1), except that X makes a distribution to the museum equal only to one-half of the contribution from M, that the remainder of such contribution is added to X's funds and used to pay charitable administrative expenses, and that the records obtained by M from X are not sufficient to show the amounts distributed or the identities of the recipients of the distributions. The contribution by M to X will be a qualifying distribution only to the extent that M can obtain (i) other sufficient evidence (such as statements from officers or employees of X or from the museum) showing the facts required by subparagraph (1)(ii) (*a*), (*b*), and (*c*) of this paragraph and (ii) a statement from X setting forth that the remainder of the contribution was used for charitable administrative expenses which constituted qualifying distributions described in paragraph (a)(2)(i) of this section.

Example 4. X and Y are private nonoperating foundations. A is an exempt organization which is not described in section 501(c)(3) but which supervises and conducts a program described in section 170(c)(2)(B). Y, but not X, controls A within the meaning of paragraph (a)(3) of this section. In 1972, X and Y each makes a grant to A of $100, specifically designated for use in the operation of A's section 170(c)(2)(B) program. X has made a qualifying distribution to A because the distribution is one described in paragraph (a)(2)(i) of this section. However, because A is controlled by Y, Y's grant of $100 to A does not constitute a qualifying distribution within the meaning of such paragraph (a)(2)(i). Furthermore, because A is not an exempt organization described in section 501(c)(3), Y's grant to A does not constitute a qualifying distribution by operation of the provisions of this paragraph.

Example 5. N, a private nonoperating foundation, had distributable amounts of $100 in 1970 and $125 in 1971. In 1970 N received total contributions of $540: $150 from Y, a public charity; $70 from Z, a private foundation; $140 from Q, a private foundation, subject to the requirement that N earmark the amount and distribute it before distributing Z's contribution; and, $180 from R, also a private foundation. However, R specifically instructed N that such contribution did not have to be redistributed because R already had made enough qualifying distributions to avoid all section 4942 taxes. N is not controlled by Y, Z, Q, or R, and N made no qualifying distributions in 1970. By the close of 1971, N had made qualifying distributions of $420, earmarking $140 as having been a distribution of Q's contribution, but had made no election under paragraph (d)(2) of this section to have any amount distributed which was in excess of N's 1970 undistributed income treated as distributed out of corpus. Therefore, the first $225 of qualifying distributions made in 1971 (the sum of $100 and $125, N's distributable amounts for 1970 and 1971, respectively) are treated as amounts described in paragraph (d)(1) (i) and (ii) of this section. Since Y's contribution is a contribution from a public charity and does not have to be ''redistributed'' and since R specifically instructed N that its contribution need not be ''redistributed'', the remaining $195 of qualifying distributions will be treated as distributed pro rata from Z's and Q's contributions, regardless of N's earmarking. Accordingly, of Z's original qualifying distribution of $70 only $65 ($195 multiplied by $70, Z's contribution, over $210, the total ($70 plus $140) of Z's and Q's contributions) will be treated as redistributed by N. Similarly, of Q's original qualifying distribution of $140 only $130 ($195 multiplied by $140 over $210) will be treated as redistributed by N. Thus, Z's gross income for 1972 will be increased by $5 ($70 less the $65 actually redistributed), and Q's gross income for 1972 will be increased by $10 ($140 less the $130 actually redistributed).

(4) *Limitation.* A contribution by a private foundation to a donee organization which the donee uses to make payments to another organization (the secondary donee) shall not be regarded as a contribution by the private foundation to the secondary donee if the distributing foundation does not earmark the use of the contribution for any named secondary donee and does not retain power to cause the selection of the secondary donee by the organization to which such foundation has made the contribution. For purposes of this subparagraph, a contribution described herein shall not be regarded as a contribution by the foundation to the secondary donee even though such foundation has reason to believe that certain organizations would derive benefits from such contribution so long as the original donee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of such foundation.

(5) *Transitional rule.* (i) For purposes of this paragraph, a contribution to a private foundation which is not an operating foundation and which is not controlled (directly or indirectly) by the distributing foundation or one or more disqualified persons with respect to the distributing foundation will be treated as a contribution to an operating foundation if:

(*a*) Such contribution is made pursuant to a written commitment which was binding on May 26, 1969, and at all times thereafter.

(*b*) Such contribution is made for one or more of the purposes described in section 170(c) (1) or (2)(B), and

(*c*) Such contribution is to be paid out to the donee private foundation on or before December 31, 1974.

(ii) For purposes of this subparagraph, a written commitment will be considered to have been binding prior to May 27, 1969, only if the amount and nature of the contribution and the name of the donee foundation were entered in the records of the distributing foundation, or were otherwise adequately evidenced, prior to May 27, 1969, or notice of the contribution was communicated in writing to such donee prior to May 27, 1969.

(d) *Treatment of qualifying distributions*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, any qualifying distribution made during a taxable year shall be treated as made:

(i) First out of the undistributed income (as defined in paragraph (a) of § 53.4942(a)–2) of the immediately preceding taxable year (if the private foundation was subject to the initial excise tax imposed by section 4942(a) for such preceding taxable year) to the extent thereof;

(ii) Second out of the undistributed income for the taxable year to the extent thereof; and

(iii) Then out of corpus.

(2) *Election*. In the case of any qualifying distribution which (under subparagraph (1) of this paragraph) is not treated as made out of the undistributed income of the immediately preceding taxable year, the foundation may elect to treat any portion of such distribution as made out of the undistributed income of a designated prior taxable year or out of corpus. Such election must be made by filing a statement with the Commissioner during the taxable year in which such qualifying distribution is made or by attaching a statement to the return the foundation is required to file under section 6033 with respect to the taxable year in which such qualifying distribution was made. Such statement must contain a declaration by an appropriate foundation manager (within the meaning of section 4946(b)(1)) that the foundation is making an election under this subparagraph, and it must specify whether the distribution is made out of the undistributed income of a designated prior taxable year (or years) or is made out of corpus. In any case where the election described in this subparagraph is made during the taxable year in which the qualifying distribution is made, such election may be revoked in whole or in part by filing a statement with the Commissioner during such taxable year revoking such election in whole or in part or by attaching a statement to the return the foundation is required to file under section 6033 with respect to the taxable year in which the qualifying distribution was made revoking such election in whole or in part. Such statement must contain a declaration by an appropriate foundation manager (within the meaning of section 4946(b)(1)) that the foundation is revoking an election under this subparagraph in whole or in part, and it must specify the election or part thereof being revoked.

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

Example 1. M, a private foundation which was created in 1968 and which uses the calendar year as the taxable year, has distributable amounts and qualifying distributions for 1970 through 1976 as follows:

	1970	1971	1972	1973
Distributable amount	$100	$100	$100	$100
Qualifying distribution	0	100	250	100
	1974	1975	1976	.....
Distributable amount	$100	$100	$100	.....
Qualifying distribution	100	100	100	.....

In 1971 the qualifying distribution of $100 is treated under subparagraph (1)(i) of this paragraph as made out of the $100 of undistributed income for 1970. The qualifying distribution of $250 in 1972 is treated as made: (i) $100 out of the undistributed income for 1971 under subparagraph (1)(i) of this paragraph; (ii) $100 out of the undistributed income for 1972 under subparagraph (1)(ii) of this paragraph; and (iii) $50 out of corpus in 1972 under subparagraph (1)(iii) of this paragraph. The qualifying distribution of $100 in each of the years 1973 through 1976 is treated as made out of the undistributed income for each of those respective years under subparagraph (1)(ii) of this paragraph. See paragraph (e) of this section for rules relating to the carryover of qualifying distributions out of corpus.

Example 2. *M*, a private foundation which uses the calendar year as the taxable year, has undistributed income of $300 for 1981, $200 for 1982, and $400 for 1983. On January 14, 1983, *M* makes its first qualifying distribution in 1983 when it sets aside (within the meaning of paragraph (b) of this section) $700 for construction of a hospital. On February 24, 1983 a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) in regard to *M*'s undistributed income for 1981 is mailed to *M* under section 6212(a). *M* notifies the Commissioner in writing on March 24, 1983, that it is making an election under subparagraph (2) of this paragraph to have its distribution of January 14th applied first against its undistributed income for 1982, next against its undistributed income for 1981, and last against its undistributed income for 1983. Thus, $200 of the $700 qualifying distribution is treated as made out of the undistributed income for 1982; $300, out of undistributed income for 1981; and $200 ($700 less the sum of $200 and $300), out of the undistributed income for 1983. Thus, an initial excise tax of $45 (15 percent of $300) is imposed under section 4942(a). Since *M* made the election described above, the $300 (treated as distributed out of undistributed income for 1981) corrects (within the meaning of section 4963(d)(2)) the taxable act because the undistributed income for 1981 is reduced to zero. Furthermore, correction is effected within the correction period (as defined in section 4963(e)(1) and § 53.4963–1(e)). Therefore, under the provisions of section

4961(a), the additional tax imposed by section 4942(b) will not be assessed.

(e) *Carryover of excess qualifying distributions*—(1) *In general.* If in any taxable year for which an organization is subject to the initial excise tax imposed by section 4942(a) there is created an excess of qualifying distributions (as determined under subparagraph (2) of this paragraph), such excess may be used to reduce distributable amounts in any taxable year of the adjustment period (as defined subparagraph (3) of this paragraph). For purposes of section 4942, including paragraph (d) of this section, the distributable amount for a taxable year in the adjustment period shall be reduced to the extent of the lesser of (i) the excess of qualifying distributions made in prior taxable years to which such adjustment period applies or (ii) the remaining undistributed income at the close of such taxable year after applying any qualifying distributions made in such taxable year to the distributable amount for such taxable year (determined without regard to this paragraph). If during any taxable year of the adjustment period there is created another excess of qualifying distributions, such excess shall not be taken into account until any earlier excess of qualifying distributions has been completely applied against distributable amounts during its adjustment period.

(2) *Excess qualifying distributions.* An excess of qualifying distributions is created for any taxable year beginning after December 31, 1969, if:

(i) The total qualifying distributions treated (under paragraph (d) of this section) as made out of the undistributed income for such taxable year or as made out of corpus with respect to such taxable year (other than amounts distributed by an organization in satisfaction of section 170(b)(1)(E)(ii) or paragraph (c) of this section, or applied to a prior taxable year by operation of the elections contained in paragraphs (c)(2)(iv) and (d)(2) of this section), exceeds

(ii) The distributable amount for such taxable year (determined without regard to this paragraph).

(3) *Adjustment period.* For purposes of this paragraph, the taxable years in the adjustment period are the 5 taxable years immediately following the taxable year in which the excess of qualifying distributions is created. Thus, an excess (within the meaning of subparagraph (2) of this paragraph) for any 1 taxable year cannot be carried over beyond the succeeding 5 taxable years. However, if during any taxable year in the adjustment period an organization ceases to be subject to the initial excise tax imposed by section 4942(a), any portion of the excess of qualifying distributions, which prior to such taxable year has not been applied against distributable amounts, may not be carried over to such taxable year or subsequent taxable years in the adjustment period, even if during any of such taxable years the organization again becomes subject to the initial excise tax imposed by section 4942(a).

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

Example 1. (i) F, a private foundation which was created in 1967 and which uses the calendar year as the taxable year, has distributable amounts and qualifying distributions for 1970 through 1976 as follows:

Year	1970	1971	1972	1973
Distributable amount	$100	$100	$100	$100
Qualifying distribution	0	$250	$70	$140

Year	1974	1975	1976	
Distributable amount	$100	$100	$100	.....
Qualifying distribution	$60	$75	$105	.....

(ii) The qualifying distributions made in 1971 will be treated under paragraph (d) of this section as $100 made out of the undistributed income for 1970, then as $100 made out of the undistributed income for 1971, and finally as $50 out of corpus in 1971. Since the total qualifying distributions for 1971 ($150) exceed the distributable amount for 1971 ($100), there exists a $50 excess of qualifying distributions which F may use to reduce its distributable amounts for the years 1972 through 1976 (the taxable years in the adjustment period with respect to the 1971 excess). Therefore, the $100 distributable amount for 1972 is reduced by $30 (the lesser of the 1971 excess ($50) and the remaining undistributed income at the close of 1972 ($30), after the qualifying distributions of $70 for 1972 were applied to the original distributable amount for 1972 of $100). Since the distributable amount for 1972 was reduced to $70, there is no remaining undistributed income for 1972. Accordingly, the qualifying distributions made in 1973 will be treated as $100 made out

of the undistributed income for 1973 and as $40 out of corpus in 1973. Since this amount ($140) exceeds the distributable amount for 1973 ($100), there exists a $40 excess which F may use to reduce its distributable amounts for the years 1974 through 1978 (the taxable years in the adjustment period with respect to the 1973 excess). However, in accordance with subparagraph (1) of this paragraph such excess may not be used to reduce F's distributable amounts for the years 1974 through 1976 until the excess created in 1971 has been completely applied against distributable amounts during such years. The distributable amount for 1974 is reduced by $40 (the lesser of the unused portion of the 1971 excess ($20) plus the 1973 excess ($40) and the remaining undistributed income at the close of 1974 ($40), after the qualifying distributions of $60 for 1974 were applied to the original distributable amount for 1974 of $100). The distributable amount for 1975 is reduced by $20 (the lesser of the unused portion of the 1973 excess of qualifying distributions ($20) and the remaining undistributed income at the close of 1975 ($25), after the qualifying distributions of $75 for 1975 were applied to the original distributable amount for 1975 of $100). Consequently, qualifying distributions made in 1976 will be treated as made first out of the $5 of remaining undistributed income for 1975 and then as $100 made out of the undistributed income for 1976.

Example 2. Assume the facts as stated in example (1), except that in 1974 F receives a contribution of $300 from G, a private foundation which controls F (within the meaning of paragraph (a)(3) of this section), and F distributes such contribution in 1975 in satisfaction of paragraph (c) of this section. Under these circumstances, there would be no excess of qualifying distributions for 1975 with respect to such distribution, since such distribution is excluded from the computation of an excess of qualifying distributions by operation of subparagraph (2)(i) of this paragraph.

Example 3. Assume the facts as stated in example (1), except that in 1972 F is treated as an operating foundation (as such term is defined in section 4942(j)(3)). In accordance with subparagraph (3) of this paragraph since F is not subject to the initial excise tax imposed by section 4942(a) for 1972, the 1971 excess cannot be carried forward to 1972 or any subsequent year in the adjustment period with respect to the 1971 excess, even if F is subsequently treated as a private nonoperating foundation for any year during the period 1973 through 1976.

[T.D. 7256, 38 FR 3323, Feb. 5, 1973, as amended by T.D. 7486, 42 FR 24265, May 13, 1977; T.D. 7849, 47 FR 50857, Nov. 10, 1982; T.D. 7938, 49 FR 3848, Jan. 31, 1984; T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4942(b)–1 Operating foundations.

(a) *Operating foundation defined*—(1) *In general.* For purposes of section 4942 and the regulations thereunder, the term ''operating foundation'' means any private foundation which, in addition to satisfying the assets test, the endowment test or the support test set forth in § 53.4942(b)–2 (a), (b) and (c), makes qualifying distributions (within the meaning of § 53.4942(a)–3(a)(2)) directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose equal in value to:

(i) For taxable years beginning before January 1, 1982, substantially all of the foundation's adjusted net income (as defined in § 53.4942(a)–2(d)); and

(ii) For taxable years beginning after December 31, 1981, substantially all of the lesser of the foundation's adjusted net income (as defined in § 53.4942(a)–2(d)) or minimum investment return (as defined in § 53.4942(a)–2(c)). If the foundation's qualifying distributions exceed its minimum investment return (but are less than the foundation's adjusted net income) substantially all of such qualifying distributions must be made directly for the active conduct of activities constituting its charitable, educational or other similar exempt purpose. However, if the foundation's minimum investment return is less than its adjusted net income and the foundation's qualifying distributions equal or exceed such adjusted net income, only that portion of the qualifying distributions equal to substantially all of the foundation's adjusted net income must be made directly for the active conduct of activities constituting its charitable, educational or other similar exempt purpose.

(2) *Certain elderly care facilities described in section 4942(j)(6)*—(i) *In general.* For purposes of the distribution requirements of section 4942 (but no other provision of the Internal Revenue Code) and for taxable years beginning after December 31, 1969, the term ''operating foundation'' includes a private foundation which:

(A) On or before May 26, 1969, and continuously thereafter to the close of the taxable year, operates and maintains, as its principal functional purpose, residential facilities for the long-

term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children, and

(B) Satisfies the endowment test set forth in § 53.4942(b)–2 (b).

(ii) *Principal functional purpose.* For purposes of section 4942(j)(6) and this subparagraph (2), an organization's ''principal functional purpose'' is operating and maintaining residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children, if it is organized for the principal purpose of operating and maintaining such residential facilities and is primarily engaged directly in the operation and maintenance of those facilities. An organization will be treated as being primarily engaged directly in the operation and maintenance of the described residential facilities if at least 50% of the qualifying distributions (as defined in § 53.4942(a)–3(a)(2)) normally made by the organization are expended for the operation and maintenance of the facilities.

(b) *Active conduct of activities constituting the exempt purpose*—(1) *In general.* For purposes of this section, except as provided in subparagraph (2) or (3) of this paragraph, qualifying distributions are not made by a foundation ''directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose'' unless such qualifying distributions are used by the foundation itself, rather than by or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation. Thus, grants made to other organizations to assist them in conducting activities which help to accomplish their charitable, educational, or other similar exempt purpose are considered an indirect, rather than direct, means of carrying out activities constituting the charitable, educational, or other similar exempt purpose of the grantor foundation, regardless of the fact that the exempt activities of the grantee organization may assist the grantor foundation in carrying out its own exempt activities. However, amounts paid to acquire or maintain assets which are used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, public park, or historic site, are considered direct expenditures for the active conduct of the foundation's exempt activities. Likewise, administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the foundation's exempt activities (regardless of whether they are ''directly for the active conduct'' of such exempt activities) shall be treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are reasonable in amount. Conversely, administrative expenses and operating costs which are not attributable to exempt activities, such as expenses in connection with the production of investment income, are not treated as such qualifying distributions. Expenses attributable to both exempt and nonexempt activities shall be allocated to each such activity on a reasonable and consistently applied basis. Any amount set aside by a foundation for a specific project, such as the acquisition and restoration, or construction, of additional buildings or facilities which are to be used by the foundation directly for the active conduct of the foundation's exempt activities, shall be deemed to be qualifying distributions expended directly for the active conduct of the foundation's exempt activities if the initial setting aside of the funds constitutes a set-aside within the meaning of paragraph (b) of § 53.4942(a)–3.

(2) *Payments to individual beneficiaries*—(i) *In general.* If a foundation makes or awards grants, scholarships, or other payments to individual beneficiaries (including program related investments within the meaning of section 4944(c) made to individuals or corporate enterprises) to support active programs conducted to carry out the foundation's charitable, educational, or other similar exempt purpose, such grants, scholarships, or other payments will be treated as qualifying distributions made directly for the active conduct of exempt activities for purposes of paragraph (a) of this section only if the foundation, apart from the

making or awarding of the grants, scholarships, or other payments, otherwise maintains some significant involvement (as defined in subdivision (ii) of this subparagraph) in the active programs in support of which such grants, scholarships, or other payments were made or awarded. Whether the making or awarding of grants, scholarships, or other payments constitutes qualifying distributions made directly for the active conduct of the foundation's exempt activities is to be determined on the basis of the facts and circumstances of each particular case. The test applied is a qualitative, rather than a strictly quantitative, one. Therefore, if the foundation maintains a significant involvement (as defined in subdivision (ii) of this subparagraph) it will not fail to meet the general rule of subparagraph (1) of this paragraph solely because more of its funds are devoted to the making or awarding of grants, scholarships, or other payments than to the active programs which such grants, scholarships, or other payments support. However, if a foundation does no more than select, screen, and investigate applicants for grants or scholarships, pursuant to which the recipients perform their work or studies alone or exclusively under the direction of some other organization, such grants or scholarships will not be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities. The administrative expenses of such screening and investigation (as opposed to the grants or scholarships themselves) may be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities.

(ii) *Definition.* For purposes of this subparagraph, a foundation will be considered as maintaining a ''significant involvement'' in a charitable, educational, or other similar exempt activity in connection with which grants, scholarships, or other payments are made or awarded if:

(A) An exempt purpose of the foundation is the relief of poverty or human distress, and its exempt activities are designed to ameliorate conditions among a poor or distressed class of persons or in an area subject to poverty or national disaster (such as providing food or clothing to indigents or residents of a disaster area), the making or awarding of the grants or other payments to accomplish such exempt purpose is direct and without the assistance of an intervening organization or agency, and the foundation maintains a salaried or voluntary staff of administrators, researchers, or other personnel who supervise and direct the activities described in this subdivision (A) on a continuing basis; or

(B) The foundation has developed some specialized skills, expertise, or involvement in a particular discipline or substantive area (such as scientific or medical research, social work, education, or the social sciences), it maintains a salaried staff of administrators, researchers, or other personnel who supervise or conduct programs or activities which support and advance the foundation's work in its particular area of interest, and, as a part of such programs or activities, the foundation makes or awards grants, scholarships, or other payments to individuals to encourage and further their involvement in the foundation's particular area of interest and in some segment of the programs or activities carried on by the foundation (such as grants under which the recipients, in addition to independent study, attend classes, seminars, or conferences sponsored or conducted by the foundation, or grants to engage in social work or scientific research projects which are under the general direction and supervision of the foundation).

(3) *Payment of section 4940 tax.* For purposes of section 4942(j)(3) (A) and (B)(ii), payment of the tax imposed upon a foundation under section 4940 shall be considered a qualifying distribution which is made directly for the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose.

(c) *Substantially all.* For purposes of this section, the term ''substantially all'' shall mean 85 percent or more. Thus, if a foundation makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount equal

to at least 85 percent of its adjusted net income, it will be considered as satisfying the income test described in this section even if it makes grants to organizations or engages in other activities with the remainder of its adjusted net income and with other funds. In determining whether the amount of qualifying distributions made directly for the active conduct of such exempt activities equals at least 85 percent of a foundation's adjusted net income, a foundation is not required to trace the source of such expenditures to determine whether they were derived from income or from contributions.

(d) *Examples.* The provisions of this section may be illustrated by the following examples. It is assumed that none of the organizations described in these examples is described in section 509(a) (1), (2), or (3).

Example 1. N, an exempt museum described in section 501(c)(3), was founded by the gift of an endowment from a single contributor. N uses 90 percent of its adjusted net income to operate the museum. If N satisfies one of the tests set forth in § 53.4942(b)–2 it may be classified as an operating foundation since substantially all of the qualifying distributions made by N are used directly for the active conduct of N's exempt activities within the meaning of paragraph (b)(1) of this section.

Example 2. M, an exempt organization described in section 501(c)(3), was created to improve conditions in a particular urban ghetto. M receives its funds primarily from a limited number of wealthy contributors interested in helping carry out its exempt purpose. M's program consists of making a survey of the problems of the ghetto to determine the areas in which its funds may be applied most effectively. Approximately 10 percent of M's adjusted net income is used to conduct this survey. The balance of its income is used to make grants to other nonprofit organizations doing work in the ghetto in those areas determined to have the greatest likelihood of resulting in improved conditions. Under these circumstances, since only 10 percent of M's adjusted net income may be considered as constituting qualifying distributions made directly for the active conduct of M's exempt activities, M cannot qualify as an operating foundation.

Example 3. Assume the facts as stated in example (2), except that M uses the remaining 90 percent of its adjusted net income for the following purposes: (1) M maintains a salaried staff of social workers and researchers who analyze its surveys and make recommendations as to methods for improving ghetto conditions; (2) M makes grants to independent social scientists who assist in these analyses and recommendations; (3) M publishes periodic reports indicating the results of its surveys and recommendations; (4) M makes grants to social workers and others who act as advisers to nonprofit organizations, as well as small business enterprises, functioning in the community (these advisers acting under the general direction of M attempt to implement M's recommendations through their advice and assistance to the nonprofit organizations and small business enterprises); and (5) M makes grants to other social scientists who study and report on the success of the various enterprises which attempt to implement M's recommendations. Under these circumstances, M satisfies the requirements of paragraph (b) (2) of this section, and the various grants it makes constitute qualifying distributions made directly for the active conduct of its exempt activities. Thus, if M satisfies one of the tests set forth in § 53.4942(b)–2 it may be classified as an operating foundation.

Example 4. P, an exempt educational organization described in section 501(c)(3), was created for the purpose of training teachers for institutions of higher education. Each year P awards a substantial number of fellowships to students for graduate study leading toward their M.A. or Ph. D. degrees. The applicants for these fellowships are carefully screened by P's staff, and only those applicants who indicate a strong interest in teaching in colleges or universities are chosen. P publishes and circulates various pamphlets encouraging a development of interest in college teaching and describing its fellowships. P also conducts annual summer seminars which are attended by its fellowship recipients, its staff, consultants, and other interested parties. The purpose of these seminars is to foster and encourage the development of college teaching. P publishes a report of the seminar proceedings along with related studies written by those who attended. Despite the fact that a substantial portion of P's adjusted net income is devoted to granting fellowships, its commitment to encouraging individuals to become teachers at institutions of higher learning, its maintenance of a staff and programs designed to further this purpose, and the granting of fellowships to encourage involvement both in its own seminars and in its exempt purpose indicate a significant involvement by P beyond the mere granting of fellowships. Thus, the fellowship grants made by P constitute qualifying distributions made directly for the active conduct of P's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 5. Q, an exempt organization described in section 501(c) (3), is composed of professional organizations interested in different branches of one academic discipline. Q

trains its own professional staff, conducts its own program of research, selects research topics, screens and investigates grant recipients, makes grants to those selected, and sets up and conducts conferences and seminars for the grantees. Q has particular knowledge and skill in the given discipline, carries on activities to advance its study of that discipline, and makes grants to individuals to enable them to participate in activities which it conducts in carrying out its exempt purpose. Under these circumstances, Q's grants constitute qualifying distributions made directly for the active conduct of Q's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 6. R, an exempt medical research organization described in section 501 (c) (3), was created to study and perform research concerning heart disease. R has its own research center in which it carries on a broad number of research projects in the field of heart disease with its own professional staff. Physicians and scientists who are interested in special projects in this area present the plans for their projects to R. The directors of R study these plans and decide if the project is feasible and will further the work being done by R. If it is, R makes a grant to the individual to enable him to carry out his project, either at R's facilities or elsewhere. Reports of the progress of the project are made periodically to R, and R exercises a certain amount of supervision over the project. The resulting findings of these projects are usually published by R. Under these circumstances, the grants made by R constitute qualifying distributions made directly for the active conduct of R's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 7. S, an exempt organization described in section 501(c) (3), maintains a large library of manuscripts and other historical reference material relating to the history and development of the region in which the collection is located. S makes a limited number of annual grants to enable post-doctoral scholars and doctoral candidates to use its library. Sometimes S obtains the right to publish the scholar's work, although this is not a prerequisite to the receipt of a grant. The primary criterion for selection of grant recipients is the usefulness of the library's resources to the applicant's field of study. Under these circumstances, the grants made by S constitute qualifying distributions made directly for the active conduct of S's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 8. T, an exempt charitable organization described in section 501(c)(3), was created by the members of one family for the purpose of relieving poverty and human suffering. T has a large salaried staff of employees who operate offices in various areas throughout the country. Its employees make gifts of food and clothing to poor persons in the area serviced by each office. On occasion, T also provides temporary relief in the form of food and clothing to persons in areas stricken by natural disasters. If conditions improve in one poverty area, T transfers the resources of the office in that area to another poverty area. Under these circumstances, the gifts of food and clothing made by T constitute qualifying distributions made directly for the active conduct of T's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 9. U, an exempt scientific organization described in section 501(c) (3), was created for the principal purpose of studying the effects of early childhood brain damage. U conducts an active and continuous research program in this area through a salaried staff of scientists and physicians. As part of its research program, U awards scholarships to young people suffering mild brain damage to enable them to attend special schools equipped to handle such problems. The recipients are periodically tested to determine the effect of such schooling upon them. Under these circumstances, the scholarships awarded by U constitute qualifying distributions made directly for the active conduct of U's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 10. O, an exempt charitable organization described in section 501(c) (3), was created for the purpose of giving scholarships to children of the employees of X Corporation who meet the standards set by O. O not only screens and investigates each applicant to make sure that he complies with the academic and financial requirements set for scholarship recipients, but also administers an examination which each applicant must take—90 percent of O's adjusted net income is used in awarding these scholarships to the chosen applicants. O does not conduct any activities of an educational nature on its own. Under these circumstances, O is not using substantially all of its adjusted net income directly for the active conduct of its exempt activities within the meaning of paragraph (b) of this section. Thus, O is not an operating foundation because it fails to satisfy the income test set forth in paragraph (a) of this section.

[T.D. 7249, 38 FR 768, Jan. 4, 1973, as amended by T.D. 7718, 45 FR 58520, Sept. 4, 1980; 46 FR 11254, Feb. 6, 1981; T.D. 7878, 48 FR 11943, Mar. 22, 1983]

§ 53.4942(b)–2 Alternative tests.

(a) *Assets test*—(1) *In general*. A private foundation will satisfy the assets test under the provisions of this paragraph if substantially more than half of the foundation's assets:

(i) Are devoted directly (A) to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose, (B) to functionally related businesses (as defined in paragraph (c)(3)(iii) of § 53.4942(a)–2), or (C) to any combination thereof;

(ii) Are stock of a corporation which is controlled by the foundation (within the meaning of section 368(c)) and substantially all the assets of which (within the meaning of paragraph (c) of § 53.4942(b)–1) are so devoted; or

(iii) Are in part assets which are described in subdivision (i) of this subparagraph and in part stock which is described in subdivision (ii) of this subparagraph.

(2) *Qualifying assets*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, an asset is ''devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose'' only if the asset is actually used by the foundation directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose. Thus, such assets as real estate, physical facilities or objects (such as museum assets, classroom fixtures and equipment, and research facilities), and intangible assets (such as patents, copyrights, and trademarks) will be considered qualifying assets for purposes of this paragraph to the extent they are used directly for the active conduct of the foundation's exempt activities. However, assets which are held for the production of income, for investment, or for some other similar use (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not devoted directly to the active conduct of the foundation's exempt activities, even though the income derived from such assets is used to carry out such exempt activities. Whether an asset is held for the production of income, for investment, or for some other similar use rather than being used for the active conduct of the foundation's exempt activities is a question of fact. For example, an office building used for the purpose of providing offices for employees engaged in the management of endowment funds of the foundation is not devoted to the active conduct of the foundation's exempt activities. However, where property is used both for exempt purposes and for other purposes, if such exempt use represents 95 percent or more of the total use, such property shall be considered to be used exclusively for an exempt purpose. Property acquired by a foundation to be used in carrying out the foundation's exempt purpose may be considered as devoted directly to the active conduct of such purpose even though the property, in whole or in part, is leased for a limited period of time during which arrangements are made for its conversion to the use for which it was acquired, provided such income-producing use of the property does not exceed a reasonable period of time. Generally, 1 year shall be deemed to be a reasonable period of time for purposes of the immediately preceding sentence. Similarly, where property is leased by a foundation in carrying out its exempt purpose and where the rental income derived from such property by the foundation is less than the amount which would be required to be charged in order to recover the cost of purchase and maintenance of such property (taking into account the deductions permitted by paragraph (d)(4) of § 53.4942(a)–2), such property shall be considered devoted directly to the active conduct of the foundation's exempt activities.

(ii) *Limitations.* (A) Assets which are held for the purpose of extending credit or making funds available to members of a charitable class (including any interest in a program related-investment, except as provided in paragraph (b)(2) of § 53.4942(b)–1) are not considered assets devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose. For example, assets which are set aside in special reserve accounts to guarantee student loans made by lending institutions will not be considered assets devoted directly to the active conduct of the foundation's exempt activities.

(B) Any amount set aside by a foundation within the meaning of paragraph (b) (1) of § 53.4942(b)–1 shall not be treated as an asset devoted directly to

the active conduct of the foundation's exempt activities.

(3) *Assets held for less than a taxable year*. For purposes of this paragraph, any asset which is held by a foundation for part of a taxable year shall be taken into account for such taxable year by multiplying the fair market value of such asset (as determined pursuant to subparagraph (4) of this paragraph) by a fraction, the numerator of which is the number of days in such taxable year that the foundation held such asset and the denominator of which is the number of days in such taxable year.

(4) *Valuation*. For purposes of this paragraph, all assets shall be valued at their fair market value. Fair market value shall be determined in accordance with the rules set forth in paragraph (c)(4) of §53.4942(a)–2, except in the case of assets which are devoted directly to the active conduct of the foundation's exempt activities and for which neither a ready market nor standard valuation methods exist (such as historical objects or buildings, certain works of art, and botanical gardens). In such cases, the historical cost (unadjusted for depreciation) shall be considered equal to fair market value unless the foundation demonstrates that fair market value is other than cost. In any case in which the foundation so demonstrates that the fair market value of an asset is other than historical cost, such substituted valuation may be used for the taxable year for which such new valuation is demonstrated and for each of the succeeding 4 taxable years if the valuation methods and procedures prescribed by paragraph (c)(4)(iv)(B) of §53.4942 (a)–2 are followed.

(5) *Substantially more than half*. For purposes of this paragraph, the term *substantially more than half* shall mean 65 percent or more.

(6) *Examples*. The provisions of this paragraph may be illustrated by the following examples. It is assumed that none of the organizations described in these examples is described in section 509(a) (1), (2), or (3).

Example 1. W, an exempt organization described in section 501(c)(3), is devoted to the maintenance and operation of a historic area for the benefit of the general public. W has acquired and erected facilities for lodging and other visitor accommodations in such area, which W operates through a wholly owned, separately incorporated, taxable entity. These facilities comprise substantially all of the subsidiary's assets. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of §53.4942(a)–2. Under these circumstances, the stock of the subsidiary will be considered as part of W's assets which may be taken into account by W in determining whether it satisfies the assets test described in this paragraph.

Example 2. M, an exempt conservation organization described in section 501(c)(3), is devoted to acquiring, preserving, and otherwise making available for public use geographically diversified areas of natural beauty. M has acquired and erected facilities for lodging and other visitor accommodations in national park areas. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of §53.4942(a)–2. Therefore, M's assets which are directly devoted to such visitor accommodations may be taken into account by M in determining whether it satisfies the assets test described in this paragraph.

Example 3. P, an exempt organization described in section 501(c)(3), is devoted to acquiring and restoring historic houses. To insure that the restored houses will be kept in the restored condition, and to make the houses more readily available for public display, P rents the houses rather than sells them once they have been restored. The rental income derived by P is substantially less than the amount which would be required to be charged in order to recover the cost of purchase, restoration, and maintenance of such houses. Therefore, such houses may be taken into account by P in determining whether it satisfies the assets test described in this paragraph.

Example 4. Z, an exempt organization described in section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80 percent of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings, such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph.

(b) *Endowment test*—(1) *In general*. A foundation will satisfy the endowment test under the provisions of this paragraph if it normally makes qualifying distributions (within the meaning of

paragraph (a)(2) of § 53.4942(a)–3) directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount not less than two-thirds of its minimum investment return (as defined in paragraph (c) of § 53.4942(a)–2). In determining whether the amount of such qualifying distributions is not less than an amount equal to two-thirds of the foundation's minimum investment return, the foundation is not required to trace the source of such expenditures to determine whether they were derived from investment income or from contributions.

(2) *Definitions.* For purposes of this paragraph, the phrase *directly for the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose* shall have the same meaning as in paragraph (b) of § 53.4942(b)–1.

(3) *Example.* This paragraph may be illustrated by the following example:

Example. X, an exempt organization described in section 501(c)(3) and not described in section 509(a) (1), (2), or (3), was created on July 15, 1970. X uses the cash receipts and disbursements method of accounting. For 1971, the fair market value of X's assets not described in paragraph (c) (2) or (3) of § 53.4942(a)–2 is $400,000. X makes qualifying distributions for 1971 directly for the active conduct of its exempt activities of $17,000. For 1971 two-thirds of X's minimum investment return is $16,000 (6 percent × $400,000 = $24,000; ⅔ × $24,000 = $16,000). Under these circumstances, X has satisfied the endowment test described in this paragraph for 1971. However, if X's qualifying distributions for 1971 directly for the active conduct of its exempt activities were only $15,000, X would not satisfy the endowment test for 1971, unless the fair market value of its assets not described in paragraph (c) (2) or (3) of § 53.4942(a)–2 were no greater than $375,000 (6 percent × $375,000 = $22,500; ⅔ × $22,500 = $15,000).

(c) *Support test*—(1) *In general.* A foundation will satisfy the support test under the provisions of this paragraph if:

(i) Substantially all of its support (other than gross investment income as defined in section 509(e)) is normally received from the general public and from five or more exempt organizations which are not described in section 4946(a)(1)(H) with respect to each other or the recipient foundation;

(ii) Not more than 25 percent of its support (other than gross investment income) is normally received from any one such exempt organization; and

(iii) Not more than half of its support is normally received from gross investment income.

(2) *Definitions and special rules.* For purposes of this paragraph:

(i) *Support.* The term *support* shall have the same meaning as in section 509(d).

(ii) *Substantially all.* The term *substantially all* shall have the same meaning as in paragraph (c) of § 53.4942(b)–1.

(iii) *Support from exempt organizations.* The support received from any one exempt organization may be counted towards satisfaction of the support test described in this paragraph only if the foundation receives support from no fewer than five exempt organizations. For example, a foundation which normally receives 20 percent of its support (other than gross investment income) from each of five exempt organizations may qualify under this paragraph even though it receives no support from the general public. However, if a foundation normally received 10 percent of its support from each of three exempt organizations and the balance of its support from sources other than exempt organizations, such support could not be taken into account in determining whether the foundation had satisfied the support test set forth in this paragraph.

(iv) *Support from the general public.* ''Support'' received from an individual, or from a trust or corporation (other than an exempt organization), shall be taken into account as support from the general public only to the extent that the total amount of the support received from any such individual, trust, or corporation during the period for determining the normal sources of the foundation's support (as set forth in § 53.4942 (b)–3) does not exceed 1 percent of the foundation's total support (other than gross investment income) for such period. In applying this 1-percent limitation, all support received by the foundation from any person and from any other person or persons standing in a relationship to such person which is described in section 4946(a)(1) (C)

through (G) and the regulations thereunder shall be treated as received from one person. For purposes of this paragraph, support received from a governmental unit described in section 170(c)(1) shall be treated as support received from the general public, but shall not be subject to the 1-percent limitation.

§ 53.4942(b)–3 Determination of compliance with operating foundation tests.

(a) *In general.* A foundation may satisfy the income test and either the assets, endowment, or support test by satisfying such tests for any 3 taxable years during a 4-year period consisting of the taxable year in question and the three immediately preceding taxable years or on the basis of an aggregation of all pertinent amounts of income or assets held, received, or distributed during such 4-year period. A foundation may not use one method for satisfying the income test described in paragraph (a) of § 53.4942(b)–1 and another for satisfying either the assets, endowment, or support test described in § 53.4942(b)–2. Thus, if a foundation satisfies the income test on the 3-out-of-4-year basis for a particular taxable year, it may not use the aggregation method for satisfying either the assets, endowment, or support test for such particular taxable year. However, the fact that a foundation has chosen one method for satisfying the tests under §§ 53.4942(b)–1 and 53.4942(b)–2 for 1 taxable year will not preclude it from satisfying such tests for a subsequent taxable year by the alternate method. If a foundation fails to satisfy the income test and either the assets, endowment, or support test for a particular taxable year under either the 3-out-of-4-year method or the aggregation method, it shall be treated as a nonoperating foundation for such taxable year and for all subsequent taxable years until it satisfies the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 for a taxable year occurring after the taxable year in which it was treated as a nonoperating foundation.

(b) *New organizations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, an organization organized after December 31, 1969, will be treated as an operating foundation only if it has satisfied the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 for its first taxable year of existence. If an organization satisfies such tests for its 1st taxable year, it will be treated as an operating foundation from the beginning of such taxable year. If such is the case, the organization will be treated as an operating foundation for its 2d and 3d taxable years of existence only if it satisfies the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 by the aggregation method for all such taxable years that it has been in existence.

(2) *Special rule.* An organization organized after December 31, 1969, will be treated as an operating foundation prior to the end of its 1st taxable year if such organization has made a good faith determination that it is likely to satisfy the income test set forth in paragraph (a) of § 53.4942(b)–1 and one of the tests set forth in § 53.4942(b)–2 for such 1st taxable year pursuant to subparagraph (1) of this paragraph. Such a ''good faith determination'' ordinarily will be considered as made where the determination is based on an affidavit or opinion of counsel of such organization that such requirements will be satisfied. Such an affidavit or opinion must set forth sufficient facts concerning the operations and support of such organization for the Commissioner to be able to determine that such organization is likely to satisfy such requirements. An organization which, pursuant to this subparagraph, has been treated as an operating foundation for its 1st taxable year, but actually fails to qualify as an operating foundation under subparagraph (1) of this paragraph for such taxable year, will be treated as a private foundation which is not an operating foundation as of the 1st day of its 2d taxable year for purposes of making any determination under the internal revenue laws with respect to such organization. The preceding sentence shall not apply if such organization establishes to the satisfaction of the Commissioner that it is likely to qualify as an operating foundation on the basis of its 2d, 3d, and 4th taxable years. Thus, if such an organization fails to qualify as an operating foundation in its 2d, 3d, or 4th taxable year after having failed in its

1st taxable year, it will be treated as a private foundation which is not an operating foundation as of the 1st day of such 2d, 3d, or 4th taxable year in which it fails to qualify as an operating foundation, except as otherwise provided by paragraph (d) of this section. Such status as a private foundation which is not an operating foundation will continue until such time as the organization is able to satisfy the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 by either the 3-out-of-4-year method or the aggregation method. For the status of grants or contributions made to such an organization with respect to sections 170 and 4942, see paragraph (d) of this section.

(c) *Transitional rule for existing organizations.* An organization organized before December 31, 1969 (including organizations deemed to be so organized by virtue of the principles of paragraph (e)(2) of § 53.4942(a)–2), but which is unable to satisfy the tests under §§ 53.4942(b)–1 and 53.4942(b)–2 for its first taxable year beginning after December 31, 1969 on the basis of its operations for taxable years prior to such taxable year by either the 3-out-of-4-year method or the aggregation method, will be treated as a new organization for purposes of paragraph (b) of this section only if:

(1) The organization changes its methods of operation prior to its first taxable year beginning after December 31, 1972 to conform to the requirements of §§ 53.4942(b)–1 and 53.4942 (b)–2;

(2) The organization has made a good faith determination (within the meaning of paragraph (b) (2) of the section) that it is likely to satisfy the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 prior to its first taxable year beginning after December 31, 1972 on the basis of its income or assets held, received, or distributed during its taxable years beginning in 1970 through 1972; and

(3) Such good faith determination is attached to the return the organization is required to file under section 6033 for its taxable year beginning in 1972.

(d) *Treatment of contributions*—(1) *In general.* The status of grants or contributions made to an operating foundation with respect to sections 170 and 4942 will not be affected until notice of change of status of such organization is made to the public (such as by publication in the Internal Revenue Bulletin), unless the grant or contribution was made after:

(i) The act or failure to act that resulted in the organization's inability to satisfy the requirements of §§ 53.4942 (b)–1 and 53.4942(b)–2, and the grantor or contributor was responsible for, or was aware of, such act or failure to act, or

(ii) The grantor or contributor acquired knowledge that the Commissioner has given notice to such organization that it would be deleted from classification as an operating foundation.

(2) *Exception.* For purposes of subparagraph (1) (i) of this paragraph, a grantor or contributor will not be considered to be responsible for, or aware of, the act or failure to act that resulted in the grantee organization's inability to satisfy the requirements of §§ 53.4942 (b)–1 and 53.4942(b)–2 if such grantor or contributor has made his grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution would not result in the inability of such grantee organization to qualify as an operating foundation. Such a statement must be signed by a foundation manager (as defined in section 4946(b)) of the grantee organization and must set forth sufficient facts concerning the operations and support of such grantee organization to assure a reasonably prudent man that his grant or contribution will not result in the grantee organization's inability to qualify as an operating foundation.

Subpart D—Taxes on Excess Business Holdings

AUTHORITY: Secs. 4943 and 7805, Internal Revenue Code of 1954, 68A Stat. 917, 83 Stat. 507; 26 U.S.C. 4943, 7805.

SOURCE: T.D. 7496, 42 FR 46285, Sept. 15, 1977, unless otherwise noted.

§ 53.4943–1 General rule; purpose.

Generally, under section 4943, the combined holdings of a private foundation and all disqualified persons (as defined in section 4946(a)) in any corporation conducting a business which is not substantially related (aside from the

need of the foundation for income or funds or the use it makes of the profits derived) to the exempt purposes of the foundation are limited to 20 percent of the voting stock in such corporation. In addition, the combined holdings of a private foundation and all disqualified persons in any unincorporated business (other than a sole proprietorship) which is not substantially related (aside from the need of the foundation for income or funds or the use it makes of the profits derived) to the exempt purposes of such foundation are limited to 20 percent of the beneficial or profits interest in such business. In the case of a sole proprietorship which is not substantially related (within the meaning of the preceding sentence), section 4943 provides that a private foundation shall have no permitted holdings. These general provisions are subject to a number of exceptions and special provisions which will be described in following sections.

§ 53.4943–2 Imposition of tax on excess business holdings of private foundations.

(a) *Imposition of initial tax*—(1) *In general*—(i) *Initial tax*. Section 4943(a)(1) imposes an initial excise tax (the ''initial tax'') on the excess business holdings of a private foundation for each taxable year of the foundation which ends during the taxable period defined in section 4943(d)(2). The amount of such tax is equal to 5 percent of the total value of all the private foundation's excess business holdings in each of its business enterprises. In determining the value of the excess business holdings of the foundation subject to tax under section 4943, the rules set forth in §§ 20.2031–1 through 20.2031–3 of this chapter (Estate Tax Regulations) shall apply.

(ii) *Disposition of certain excess business holdings within ninety days*. In any case in which a private foundation acquires excess business holdings, other than as a result of a purchase by the foundation, the foundation shall not be subject to the taxes imposed by section 4943, but only if it disposes of an amount of its holdings so that it no longer has such excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event which caused it to have such excess business holdings. Similarly, a private foundation shall not be subject to the taxes imposed by section 4943 because of its purchase of holdings where it did not know, or have reason to know of prior acquisitions by disqualified persons, but only if the foundation disposes of its excess holdings within the 90-day period described previously, and its purchase would not have created excess business holding but for such prior acquisitions by disqualified persons. In determining whether for purposes of this (ii) the foundation has disposed of such excess business holdings during such 90-day period, any disposition of holdings, by a disqualified person during such period shall be disregarded.

(iii) *Extension of ninety day period*. The period described in paragraph (a)(1)(ii) of this section, during which no tax shall be imposed under section 4943, shall be extended to include the period during which a foundation is prevented by federal or state securities laws from disposing of such excess business holdings.

(iv) *Effect of disposition subject to material restrictions*. If a private foundation disposes of an interest in a business enterprise but imposes any material restrictions or conditions that prevent the transferee from freely and effectively using or disposing of the transferred interest, then the transferor foundation will be treated as owning such interest until all such restrictions or conditions are eliminated (regardless of whether the transferee is treated for other purposes of the Code as owning such interest from the date of the transfer). However, a restriction or condition imposed in compliance with federal or state securities laws, or in accordance with the terms or conditions of the gift or bequest through which such interest was acquired by the foundation, shall not be considered a material restriction or condition imposed by a private foundation.

(v) *Foundation knowledge of acquisitions made by disqualified persons*. (A) For purposes of paragraph (a)(1)(ii) of this section, whether a private foundation will be treated as knowing, or having reason to know, of the acquisition of holdings by a disqualified person

will depend on the facts and circumstances of each case. Factors which will be considered relevant to a determination that a private foundation did not know or had no reason to know of an acquisition are: the fact that it did not discover acquisitions made by disqualified persons through the use of procedures reasonably calculated to discover such holdings; the diversity of foundation holdings; and the existence of large numbers of disqualified persons who have little or no contact with the foundation or its managers.

(B) The provisions of paragraph (a)(1)(v)(A) of this section may be illustrated by the following example:

Example. By the fifteenth day of the fifth month after the close of each taxable year, the F Foundation sends to each foundation manager, substantial contributor, person holding more than a 20% interest (as described in section 4946(a)(1)(C) in a substantial contributor, and foundation described in section 4946(a)(1)(H), a questionnaire asking such persons to list all holdings, actual or constructive, in each business enterprise in which F had holdings during the taxable year in excess of those permitted by the 2 percent de minimis rule of section 4943(c)(2)(C). In preparing the list of such enterprises, F takes into account its constructive holdings only if, during the taxable year, F (along with all related foundations described in section 4946(a)(1)(H)) owned over 2% of the voting stock, profits interest or beneficial interest in the entity actually owning the holdings constructively held by F. The questionnaire asks each such person to list the holdings in such enterprises of any persons who, because of their relationship to such disqualified person, were themselves disqualified persons (*i.e.*, members of the family (as defined in section 4946(d)), and any corporations, partnerships, trusts and estates described in section 4946(a)(1) (E) through (G) in which such person, or members of his family, had an interest). The questionnaire asks that constructive holdings be listed only if, during the taxable year, the disqualified person owned over 2% of the voting stock, profits interest or beneficial interest in the entity actually owning the holdings constructively held by such person. (Thus a disqualified person owning less than 2% of a mutual fund is not required to list his attributed share of all the securities in the portfolio of the fund.) If no response to the questionnaire is received, the foundation seeks the information requested by the questionnaire by mailing a second (but not a third) questionnaire. If a questionnaire which is returned to the foundation indicates that certain information was unavailable to the person completing the questionnaire, the foundation seeks that information directly. For example, if a disqualified person indicates that he could not find out whether a corporation described in section 4946(a)(1)(E) had holdings in the enterprise listed in the questionnaire, the foundation seeks to obtain this information directly from the corporation by mailing it a questionnaire. In such a case F may be found not to have reason to know of the acquisition of holdings by a disqualified person.

(vi) *Holdings acquired other than by purchases*. See section 4943(c)(6) and § 53.4943–6 for rules relating to the acquisition of certain holdings other than by purchase by the foundation or a disqualified person.

(2) *Special rules*. In applying subparagraph (1) of this paragraph, the tax imposed by section 4943(a)(1):

(i) Shall be imposed on the last day of the private foundation's taxable year, but

(ii) The amount of such tax and the value of the excess business holdings subject to such tax shall be determined with respect to the foundation's holdings (based upon voting power, profits or beneficial interest, or value, whichever is applicable) in any business enterprise as of that day during the foundation's taxable year when the foundation's excess holdings in such enterprise were the greatest.

In applying subdivision (ii) of this subparagraph, if a foundation's excess business holdings in a business enterprise which constitute such foundation's greatest excess holdings in such enterprise for any taxable year are maintained for 2 or more days during such taxable year, the value of such excess holdings which is subject to tax under section 4943(a)(1) shall be the greatest value of such excess holdings in such enterprise as of any day on which such greatest excess holdings are maintained during such taxable year.

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

Example 1. Y is a private foundation reporting on a calendar year basis. On January 1, 1973, Y has 20 shares of common stock in corporation N, of which five shares constitute excess business holdings. On June 1, 1973, Y

disposes of such five shares; however, because of additional acquisitions of N common stock on such date by disqualified persons with respect to Y, the remaining 15 shares of N common stock held by Y now constitute excess business holdings. There are no further acquisitions or dispositions of N common stock during 1973 by Y or its disqualified persons. Although Y's greatest holdings in N during 1973 are held between January 1, 1973, and May 31, 1973, Y's greatest excess holdings in N during 1973 are held between June 1, 1973, and December 31, 1973. Therefore, the tax specified in section 4943(a)(1) shall be computed on the basis of the greatest value of such greatest excess holdings as of any day between June 1 and December 31, 1973.

Example 2. X is a private foundation reporting on a calendar year basis. On January 1, 1972, X has 100 shares of common stock in M corporation which are excess business holdings. On such date each share of M common stock has a fair market value of $100. On February 28, 1972, in an effort to dispose of such excess business holdings, X sells 70 shares of M common stock for $120 per share (the fair market value of each share on such date) to A, an individual who is not a disqualified person within the meaning of section 4946(a). The value of $120 per share is the highest fair market value between January 1 and February 28, 1972. X disposes of no more stock in M for the reminder of calendar year 1972. On December 31, 1972, the fair market value of each share of M common stock is $80. X calculates its tax on its excess business holdings in M for 1972 as follows:

100 shares of M common stock times $120 fair market value per share as of Feb. 28, 1972	$12,000
$12,000 multiplied by rate of tax (percent)	5
Amount of tax on X foundation's excess business holdings for 1972	$600

Example 3. Assume the same facts as in Example (2) except that the sale of X to A occurs on January 7, 1973, when the fair market value of each share of M corporation common stock equals $70. A value of $100 per share is the highest fair market value of the M common stock between January 1 and January 7, 1973. On may 9, 1973, X for the first time has excess business holdings in N corporation in the form of 200 shares of N common stock. The value per share of N common stock on May 9, 1973, equals $200. X makes no disposition of the N common stock during 1973, and the value of each share of N common stock as of December 31, 1973 equals $250 (the highest value of N common stock during 1973). X calculates its tax on its excess business holdings in both M and N for 1973 as follows:

100 shares of M common stock times $100 fair market value per share	$10,000
$250 fair market value per share	$50,000
Total	$60,000
$60,000 multiplied by rate of tax (percent)	5
Amount of tax on X foundation's excess business holdings for 1973	$3,000

(b) *Additional tax.* In any case in which the initial tax is imposed under section 4943(a) with respect to the holdings of a private foundation in any business enterprise, if, at the close of the taxable period (as defined in section 4943(d)(2) and § 53.4943–9) with respect to such holdings the foundation still has excess business holdings in such enterprise, there is imposed a tax under section 4943(b) equal to 200 percent of the value of such excess holdings as of the last day of the taxable period.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4943–3 Determination of excess business holdings.

(a) *Excess business holdings*—(1) *In general.* For purposes of section 4943, the term ''excess business holdings'' means, with respect to the holdings of any private foundation in any business enterprise (as described in section 4943(d)(4)), the amount of stock or other interest in the enterprise which, except as provided in § 53.4943–2(a)(1), the foundation, or a disqualified person, would have to dispose of, or cause the disposition of, to a person other than a disqualified person (as defined in section 4946(a)) in order for the remaining holdings of the foundation in such enterprise to be permitted holdings (as defined in paragraphs (b) and (c) of this section). If a private foundation is required by section 4943 and the regulations thereunder to dispose of certain shares of a class of stock in a particular period of time and other shares of the same class of stock in a shorter period of time, any stock disposed of shall be charged first against those dispositions which must be made in such shorter period.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X has outstanding 100 shares of voting stock, with each share entitling the holder thereof to one vote. F, a private foundation, possesses 20 shares of X voting stock representing 20 percent of the voting power in X. Assume that the permitted

holdings of F in X under paragraph (b)(1) of this section are 11 percent of the voting stock in X. F, therefore, possesses voting stock in X representing a percentage of voting stock in excess of the percentage permitted by such paragraph. Such excess percentage is 9 percent of the voting stock in X, determined by subtracting the percentage of voting stock representing the permitted holdings of F in X (*i.e.*, 11 percent) from the percentage of voting stock held by F in X (I.E., 20 percent). (20% − 11%=9%). The excess business holdings of F in X are an amount of voting stock representing such excess percentage, or 9 shares of X voting stock (9 percent of 100).

(b) *Permitted holdings in an incorporated business enterprise*—(1) *In general*—(i) *Permitted holdings defined.* Except as otherwise provided in section 4943(c) (2) and (4), the permitted holdings of any private foundation in an incorporated business enterprise (including a real estate investment trust, as defined in section 856) are:

(A) 20 percent of the voting stock in such enterprise reduced (but not below zero) by

(B) The percentage of voting stock in such enterprise actually or constructively owned by all disqualified persons.

(ii) *Voting stock.* For purposes of this section, the percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors, with treasury stock and stock which is authorized but unissued being disregarded. Thus, for example, if a private foundation holds 20 percent of the shares of one class of stock in a corporation, which class is entitled to elect three directors, and such foundation holds no stock in the other class of stock, which is entitled to elect five directors, such foundation shall be treated as holding 7.5 percent of the voting stock because the class of stock it holds has 37.5 percent of such voting power, by reason of being able to elect three of the eight directors, and the foundation holds one-fifth of the shares of such class (20 percent of 37.5 percent is 7.5 percent). The fact that extraordinary corporate action (e.g., charter or by-law amendments) by a corporation may require the favorable vote of more than a majority of the directors, or of the outstanding voting stock, of such corporation shall not alter the determination of voting power of stock in such corporation in accordance with the two preceding sentences.

(2) *Nonvoting stock as permitted holdings*—(i) *In general.* In addition to those holdings permitted by paragraph (b)(1) of this section, the permitted holdings of a private foundation in an incorporated business enterprise shall include any share of nonvoting stock in such enterprise held by the foundation in any case in which all disqualified persons hold, actually or constructively, no more than 20 percent (35 percent where third persons have effective control as defined in paragraph (b)(3)(ii) of this section) of the voting stock in such enterprise. All equity interests which do not have voting power attributable to them shall, for purposes of section 4943, the classified as nonvoting stock. For this purpose, evidences of indebtedness (including convertible indebtedness), and warrants and other options or rights to acquire stock shall not be considered equity interests.

(ii) *Stock with contingent voting rights and convertible nonvoting stock.* Stock carrying voting rights which will vest only when conditions, the occurrence of which are indeterminate, have been met, such as preferred stock which gains such voting rights only if no dividends are paid thereon, will be treated as nonvoting stock until the conditions have occurred which cause the voting rights to vest. When such rights vest, the stock will be treated as voting stock that was acquired other than by purchase, but only if the private foundation or disqualified persons had no control over whether the conditions would occur. Similarly, nonvoting stock which may be converted into voting stock will not be treated as voting stock until such conversion occurs. For special rules where stock is acquired other than by purchase, see section 4943(c)(6) and the regulations thereunder.

(iii) *Example.* The provisions of this pararaph (2) may be illustrated by the following example:

Example. Assume that F, a private foundation, holds 10 percent of the single class of voting stock of corporation X, and owns 20

shares of nonvoting stock in X. Assume further that A and B, the only disqualified persons with respect to F, hold 10 percent of the voting stock of X. Under the provisions of paragraph (b)(1) of this section the 10 percent of X voting stock held by F will be classified as permitted holdings of F in X since 20 percent less the percentage of voting stock held by A and B in X is 10 percent. In addition, under the provisions of this (2), the 20 shares of X nonvoting stock will qualify as permitted holdings of F in X since the percentage of voting stock held by A and B in X is no greater than 20 percent.

(3) *Thirty-five-percent rule where third person has effective control of enterprise*—(i) *In general.* Except as provided in section 4943(c)(4), paragraph (b)(1) of this section shall be applied by substituting 35 percent for 20 percent if:

(A) The private foundation and all disqualified persons together do not hold, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and

(B) The foundation establishes to the satisfaction of the Commissioner that effective control (as defined in paragraph (b)(3)(ii) of this section) of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualfied persons.

(ii) *''Effective control'' defined.* For purposes of this subparagraph, the term ''effective control'' means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation's directors, effective control is in the hands of those individuals.

(4) *Two percent de minimis rule*—(i) *In general.* Under section 4943(c)(2)(C), a private foundation is not treated as having excess business holdings in any incorporated business enterprise in which it (together with all other private foundations (including trusts described in section 4947(a)(2)) which are described in section 4946(a)(1)(H)) actually or constructively owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock. If, however, the private foundation, together with all other private foundations which are described in section 4946(a)(1)(H), actually or constructively owns more than 2 percent of either the voting stock or the value of the outstanding shares of all classes of stock in any incorporated business enterprise, all the stock in such business enterprise classified as excess business holding under section 4943 is treated as excess business holdings. For purposes of this paragraph, any stock owned by a private foundation which is treated as held by a disqualified person under section 4943(c)(4)(B), (5), or (6) shall be treated as actually owned by the private foundation. See paragraph (b)(1) of § 53.4941(d)–4 for the determination of excess business holdings without regard to section 4943(c)(2)(C) for purposes of applying section 101(C)(2)(B) of the Tax Reform Act of 1969 (83 Stat. 533).

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. F, a private foundation, owns 1 percent of the single class of voting stock and 1 percent in value of all the outstanding shares of all classes of stock in X corporation. No other private foundation described in section 4946(a)(1)(H) owns any stock in X. All of the stock owned by F in X would be excess business holdings under section 4943 (c)(1) if section 4943(c)(2)(C) were inapplicable. F owns no no other shares of stock in X. Since F owns more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock in X, under section 4943(c)(2)(C) none of the stock in X owned by F is treated as excess business holdings.

Example 2. Assume the facts as stated in Example (1), except that F and T, a controlled private foundation under section 4946 (a)(1)(H), together own 1 percent of all the voting stock and 1 percent in value of all the outstanding shares of all classes of stock in X. All of the stock in X owned by F and T would be excess business holdings under section 4943(c)(1) if section 4943(c)(2)(C) were inapplicable. Since F and T together owned no more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock in X, under section 4943(c)(2)(C) none of the stock in X owned by either F or T is treated as excess business holdings.

Example 3. Assume the facts as stated in Example (1), except that F owns 3 percent of the voting stock in X, 2 percent of which is treated as held by P, a disqualified person of F, under section 4943(c)(4)(B). Under subdivision (i) of this subparagraph, the 2 percent of the stock in X owned by F which is treated as held by P under section 4943(c)(4)(B) is treated as actually owned by F for purposes of section 4943(c)(2)(C). Consequently, all of the X stock owned by F is treated as excess business holdings under section 4943(c)(2)(C). However, only 1 percent of the stock in X is subject to tax under section 4943(a), since the other 2 percent is treated as owned by a disqualified person under section 4943(c)(4)(B) for purposes of determining the tax upon F under section 4943(a).

(c) *Permitted holdings in an unincorporated business enterprise*—(1) *In general.* The permitted holdings of a private foundation in any business enterprise which is not incorporated shall, subject to the provisions of subparagraphs (2), (3), and (4) of this paragraph, be determined under the principles of paragraph (b) of this section.

(2) *Partnership or joint venture.* In the case of a partnership (including a limited partnership) or joint venture. the terms ''profits interest'' and ''capital interest'' shall be substituted for ''voting stock'' and ''nonvoting stock,'' respectively, wherever those terms appear in paragraph (b) of this section. The interest in profits of such foundation (or such disqualified person) shall be determined in the same manner as its distributive share of partnership taxable income. See section 704(b) (relating to the determination of the distributive share by the income or loss ratio) and the regulations thereunder. In the absence of a provision in the partnership agreement, the capital interest of such foundation (or such disqualified person) in a partnership shall be determined on the basis of its interest in the assets of the partnership which would be distributable to such foundation (or such disqualified person) upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(3) *Sole proprietorship.* For purposes of section 4943, a private foundation shall have no permitted holdings in a sole proprietorship. In the case of a transfer by a private foundation of a portion of a sole proprietorship, see paragraph (c)(2) of this section (relating to permitted holdings in partnerships). For the treatment of a private foundation's ownership of a sole proprietorship prior to May 26, 1969, see § 53.4943–4.

(4) *Trusts and other unincorporated business enterprises*—(i) *In general.* In the case of any unincorporated business enterprise which is not described in paragraph (c) (2) or (3) of this section, the term ''beneficial interest'' shall be substitued for ''voting stock'' wherever the term appears in paragraph (b) of this section. Any and all references to nonvoting stock in paragraph (b) of this section shall be inapplicable with respect to any unincorporated business enterprise described in this subparagraph.

(ii) *Trusts.* For purposes of section 4943, the beneficial interest of a private foundation or any disqualified person in a trust shall be the beneficial remainder interest of such foundation or person determined as provided in paragraph (b) of § 53.4943–8.

(iii) *Other unincorporated business enterprises.* For purposes of section 4943, the beneficial interest of a private foundation or any disqualified person in an unincorporated business enterprise (other than a trust or an enterprise described in paragraph (c) (2) or (3) of this section) includes any right to receive a portion of distributions of profits of such enterprise, and, if the portion of distributions is not fixed by an agreement among the participants, any right to receive a portion of the assets (if any) upon liquidation of the enterprise, except as a creditor or employee. For purposes of this subparagraph, a right to receive distributions of profits includes a right to receive any amount from such profits (other than as a creditor or employee), whether as a sum certain or as a portion of profits realized by the enterprise. Where there is no agreement fixing the rights of the participants in such enterprise, the interest of such foundation (or such disqualified person) in such enterprise shall be determined by dividing the amount of all equity investments or contributions to the capital of the enterprise made or obligated to be made by such foundation (or such disqualified person) by the amount of all equity investments or contributions to capital made or obligated to be

made by all participants in the enterprise.

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has outstanding 100 shares of voting stock, with each share entitling the holder thereof to one vote. Assume that F, a private foundation, possesses 30 shares of X voting stock, and that A and B, the only disqualified persons with respect to F, together own 10 shares of X voting stock. The excess business holdings of F in X are 20 shares of X voting stock, determined as follows:

(*i*) *Determination of voting stock percentages*	
(a) Total number of outstanding votes in X	100
(b) Total number of votes in X held by F	30
(c) Total number of votes in X held by A and B	10
(d) Percentage of voting stock in X held by F (item (b) divided by item (a)) (percent)	30
(e) Percentage of voting stock in X held by A and B (item (c) divided by item (a)) (percent)	10
(*ii*) *Determination of permitted holdings of voting stock*	
(a) Percentage of voting stock in X held by A and B (percent)	10
(b) Permitted holdings of voting stock by F in X (20 pct less item (a)) (percent)	10
(*iii*) *Determination of excess business holdings*	
(a) Percentage of voting stock in X held by F (percent)	30
(b) Permitted holdings of voting stock by F in X (percent)	10
(c) Item (a) less item (b) (percent)	20
(d) Excess business holdings of F in X (*i.e.*, an amount of X voting stock representing a percentage of voting stock equivalent to that in item (c)) (shares)	20

* * * * * * *

Example 2. F, a private foundation, is a partner in P partnership. In addition, A and B, the only disqualified persons with respect to F, are partners in P. The partnership agreement of P contains no provisions regarding the sharing of profits by, and the respective capital interests of, the partners.

(i) assume that, under section 704(b), F's distributive share of P taxable income is determined to be 20 percent. In addition, assume that under such section, A and B are determined to have a 4-percent distributive share each of P taxable income. Accordingly, F holds a 20-percent profits interest in P, and A and B hold an 8-percent profits interest in P. Assuming that the provisions of section 4943(c)(2)(B) do not apply, the permitted holdings of F in P are 12 percent of the profits interest in P, determined by subtracting the percentage of the profits interest held by A and B in P (*i.e.*, 8 percent) from 20 percent. (20 percent − 8 percent=12 percent.) F, therefore, holds a percentage of the profits interest in P in excess of the percentage permitted by § 53.4943–3(b)(1). The excess business holdings of F in P are a percentage of the profits interest in P equivalent to such excess percentage, or 8 percent of the profits interest in P, determined by subtracting the permitted holdings of F in P (*i.e.*, 12 percent) from the percentage of the profit interest held by F in P (*i.e.*, 20 percent) (20 percent − 12 percent=8 percent.)

(ii) Assume that, under the partnership agreement, F would be entitled to a distribution of 20 percent of P's assets upon F's withdrawal from P and to a distribution of 30 percent of P's assets upon the liquidation profits interest held by F in P (*i.e.*, 20 percent) (20 percent − 12 percent=8 percent), of P. F, therefore, holds a 30-percent capital percentage of the assets of P distributable to F upon F's withdrawal from P, or the percentage of such assets distributable to F upon the liquidation of P. Since the percentage of the profits interest held by A and B in P is less than 20 percent, such 30-percent capital interest will be included in the permitted holdings of F in P.

§ 53.4943–4 Present holdings.

(a) *Introduction*—(1) *Section 4943 (c)(4) in general.* (i) Paragraph (4) of section 4943(c) prescribes transition rules for a private foundation which, but for such paragraph, would have excess business holdings on May 26, 1969. Section 4943(c)(4) provides such a foundation with protection from the initial tax on excess business holdings in two ways. First, the entire interest of such a foundation in any business enterprise in which such a foundation, but for section 4943(c)(4), would have had excess business holdings on May 26, 1969, is treated under section 4943(c)(4)(B) as held by disqualified persons for a certain period of time (the ''first phase''). The effect of such treatment is to prevent a private foundation from being subject to the initial tax with respect to its May 26, 1969, interest during the first phase holding period and also to prevent the foundation from purchasing any additional business holdings in such business enterprise during

such period (unless the combined holdings of the foundation and all disqualified persons fall below the 20 percent (or 35 percent, if applicable) figure prescribed by section 4943(c)(2)). Second, section 4943(c)(4)(A)(i) initially increases the percentage of permitted holdings of such a foundation to a percentage equal to the difference between:

(A) The percentage of combined holdings of the foundation and all disqualified persons in such business enterprise on May 26, 1969 (subject to a 50 percent maximum), and

(B) The percentage of holdings of all disqualified persons.

The percentage referred to in paragraph (a)(1)(i)(A) of this section is referred to in this section as the ''substituted level''. This ''substituted level'' is then reduced by the ''downward ratchet rule'' prescribed by section 4943(c)(4)(A)(ii) and paragraph (d)(3) of this section for certain dispositions by such foundation or by disqualified persons. The primary purpose of the substituted level is to indicate what the permitted holdings in such business enterprise will be immediately after the expiration of the first phase holding period. Thereafter, the permitted holdings of a private foundation itself are further limited to a maximum 25 percent interest in such business enterprise by section 4943(c)(4)(D) as soon as the combined holdings of all disqualified persons in such business enterprise exceed 2 percent (of the voting stock). If the combined holdings of all disqualified persons at no time exceed 2 percent (of the voting stock) during the 15 years following the first phase (the ''second phase''), then the substituted level is reduced to a 35 percent maximum after the second phase.

(ii) Paragraph (a)(1)(i) of this section may be illustrated by the following example:

Example. On May 26, 1969, private foundation P held a 5 percent interest in corporation X (voting stock and value). On such date disqualified persons held a 16 percent interest in X (voting stock and value). Assume that except for section 4943(c)(4), P would have had a 1 percent interest in X which would have consitituted excess business holdings. Therefore, section 4943(c)(4)(B) applies and P's 5 percent interest in X is treated as held by a disqualified person during the 10-year period beginning May 26, 1969. Since the entire 21 percent held by P and disqualified persons is now treated as held by disqualified persons, P's substituted level is 21 percent and its permitted holdings are zero (21% − 21%). However, P has no excess business holdings in X, because during the 10-year period P is not treated as holding such interest. The only change in the interest in X occurs on January 2, 1972, when P disposes of 2 percent of its interest in X to A, an unrelated person. Since the interest held by P and all disqualified persons (21% − 2%=19%) has decreased below 20 percent, P's substituted level is reduced to 20 percent and its permitted holdings are 1 percent (20% − 19%) on such date. Therefore, if the other interests in X do not change, P will not have excess business holdings if P purchases no more than an additional 1 percent interest in X.

(2) *Interaction of provisions of section 4943(c) (4), (5), and (6).* During the first phase, a private foundation may acquire additional interests in a business enterprise, other than by purchase, which are entitled to be treated as held by disqualified persons for varying holding periods under section 4943(c) (5) or (6) (relating respectively to certain holdings aquired pursuant to the terms of a trust or will in effect on May 26, 1969, and to the 5-year period to dispose of certain gifts, bequests, etc.). In any case holdings which the private foundation disposes of shall be charged first against those holdings which it must dispose of in the shortest period in order to avoid the initial tax thereon. Further, acquisions of a private foundation under a pre-May 27, 1969, will or trust described in section 4943(3)(5) are treated in a manner similar to the treatment of interests actually held by a private foundation on May 26, 1969. See §§ 53.4943–5 and 53.4943–6.

(b) *Present holdings in general.* (1) Section 4943(c)(4)(B) provides that any interest in a business enterprise held by a private foundation on May 26, 1969, if the foundation on such date has excess business holdings (determined without regard to section 4943(c)(4)), shall (while held by the foundation) be treated as held by a disqualified person during a first phase. Therefore, no interest of a private foundation shall be treated as held by a disqualified person under section 4943(c)(4)(B) and this section unless:

(i) The private foundation was an entity (not including a revocable trust) in existence on May 26, 1969, even though it was not then treated as a private foundation under section 509 or section 4947;

(ii) Such interest was actually or constructively owned by such entity on such date; and

(iii) Without regard to section 4943(c)(4) such entitly had on such date an interest (considered in connection with the interests actually or constructively owned by all disqualified persons with respect to such entity on that date in the same business enterprise, determined as if the entity were then a private foundation) which exceeded the permitted holdings prescribed by section 4943(c) (2) or (3).

(See, however, section 4943(c)(5) and § 53.4943–5 for similar treatment for certain interests acquired by a private foundation under the terms of a trust or a will which were in effect on May 26, 1969.) If a private foundation owns an interest described by section 4943(c)(4)(B), then the length of the first phase for such an interest is prescribed by paragraph (c) of this section and shall not be affected by any interest acquired by the private foundation or any disqualified person in such business enterprise after May 26, 1969. In addition, the amount of permitted holdings in such business enterprise is prescribed by paragraph (d) of this section. An interest constructively held by a private foundation (or a disqualified person) on May 26, 1969, shall not cease to be an interest to which section 4943(c)(4) applies merely because it is later distributed to such foundation (or to such disqualified person). Nor shall an interest directly held by a private foundation (or to such disqualified person) on May 26, 1969, cease to be treated as an interest to which section 4943(c)(4) applies to the extent it remains actually or constructively held by such foundation (or such disqualified person) upon transfer of such interest, such as upon the incorporation of a sole proprietorship.

(2) The provision of this paragraph may be illustrated by the following example:

Example. A, a nonprofit research organization described in section 501(c)(3), was organized in 1966. On May 26, 1969, A held 50 percent of the stock of corporation B. For its taxable years 1970, 1971, and 1972, A is classified as an organization described in section 509(a)(2). However, for 1973 and subsequent years, A fails to satisfy the gross investment income limitation of section 509(a)(2)(B), and is thus classified as a private foundation. In such a case, section 4943(c)(4) applies, and a disqualified person shall be treated as holding A's stock in B during a first phase that begins on May 26, 1969.

(c) *First Phase holding periods*—(1) *In general*. If, on May 26, 1969, a private foundation has excess business holdings in any business enterprise (determined with regard to the 20 or 35 percent permitted holdings of section 4943(c)(2)), then all interest which such foundation holds, actually or constructively, in such enterprise on May 26, 1969, shall (while held by such foundation) be deemed held by a disqualified person during the following periods:

(i) The 20-year period beginning on May 26, 1969, if the private foundation holds, actually or constructively, more than 95 percent of the voting stock (or more than a 95 percent profits or beneficial interest in the case of an unincorporated enterprise) in such enterprise on such date;

(ii) Except as provided in paragraph (c)(1)(i) of this section, the 15-year period beginning on May 26, 1969, if the private foundation and all disqualified persons hold, actually or constructively on such date more than 75 percent of the voting stock (or more than a 75 percent profits or beneficial interest in the case of any unincorporated enterprise) or 75 percent of the value of all outstanding shares of all classes of stock in such enterprise (or more than a 75 percent profits and capital interest in the case of a partnership or joint venture); or

(iii) The 10-year period beginning on May 26, 1969, in any case not described in paragraph (c)(1) (i) or (ii) of this section.

The 20-year, 15-year, or 10-year period described in this subdivision (whichever applies) shall, for purposes of section 4943 and this section, be known as the ''first phase.''

(2) *Sole proprietorships*. The 20-year period described in paragraph (c)(1) of this section shall apply with respect to

any interest which a private foundation holds in a sole proprietorship on May 26, 1969. See paragraph (b) of this section for the effect of converting such an enterprise to a corporate, partnership, or other form.

(3) *Suspension of first-phase periods.* The 20-year, 15-year, or 10-year period described in paragraph (c)(1) of this section shall be suspended during the dependency of any judicial proceeding which is brought and diligently litigated by the private foundation and which is necessary to reform, or to excuse the foundation from compliance with, its governing instrument or any other instrument (as in effect on May 26, 1969) in order to allow disposition of any excess business holdings held by the foundation on May 26, 1969.

(4) *Election to shorten the period during which certain holdings of private foundations are treated as held by disqualified persons.* If, on May 26, 1969, the combined holdings of a private foundation and all disqualified persons in any one business enterprise are such as to make applicable the 15-year period referred to in paragraph (c)(1)(ii) of this section, and if, on such date, the foundation's holdings do not exceed 95 percent of the voting stock in such enterprise, then such 15-year period is shortened to the 10-year period referred to in paragraph (c)(1)(iii), if at any time before January 1, 1971, one or more individuals:

(i) Who are substantial contributors (as described in section 507(d)(2)), or members of the family within the meaning of section 4946(d) of one or more substantial contributors, to such private foundation, and

(ii) Who on May 26, 1969, held in the aggregate more than 15 percent of the voting stock in the enterprise, made an election in the manner described in 26 CFR 143.6 (rev. as of Apr. 1, 1974).

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

Example 1. Assume that F, a private foundation, owns, on May 26, 1969, 50 shares of voting stock in corporation X respresenting 50 percent of the voting power in X and 25 percent of the value of all outstanding shares of all classes of stock in X. Assume further that A and B, the only disqualified persons with respect to F, own five shares each of voting stock in X on such date. The 10 shares of voting stock in X owned by A and B together represent 10 percent of the voting power in X and 5 percent of the value of all outstanding shares of all classes of stock in X. Under the provisions of § 53.4943–3, the excess business holdings of F, in X (determined without regard to section 4943(c)(4)) as of such date are, therefore, 40 percent of X voting stock. Accordingly, since the combined holdings of F, A, and B in X are, on such date, less than 75 percent of the voting stock in X and less than 75 percent of the value of all outstanding shares of all classes of stock in X, under the provisions of section 4943(c)(4)(B)(iii), all holdings of F in X (*i.e.*, 50 percent of X voting stock) will be treated as held by a disqualified person through May 25, 1979.

Example 2. Assume the facts as stated in Example (1), except that F, on December 15, 1969, purchases an additional 10 shares of voting stock in X representing 10 percent of X voting power. Assume, further, that there were no other transactions in the stock in X during 1969. While the 50 percent of X voting stock held by F on May 26, 1969, will be deemed held by a disqualified person through May 25, 1979, the additional 10 shares of X voting stock acquired by purchase by F on December 15, 1969, will no be deemed to be so held. Accordingly, since, under the provisions of § 53.4943–3, such 10 shares represent excess business holding of F in X, such 10 shares will be subject to the imposition of tax under the provisions of section 4943(a).

Example 3. Assume the facts as stated in Example (1), except that F, on December 15, 1971 acquires an additional 10 shares of voting stock in X (representing 10 percent of X voting power) under the terms of a will which was executed before May 26, 1969, to which section 4943(c)(5) applies. While the 50 percent of X voting stock held by F on May 26, 1969, will be deemed held by a disqualified person through May 25, 1979, the additional 10 percent of X voting stock acquired by F on December 15, 1971, will, under the provisions of section 4943(c)(5), be deemed held by a disqualified person through December 14, 1981. See § 53.4943–5.

Example 4. Assume that F, a private foundation, owns on May 26, 1969, 50 shares of voting stock in corporation Y representing 50 percent of the voting power in Y. Assume further that C and D, the only disqualified persons with respect to F, own on such date 15 shares each of Y voting stock and that the 30 shares of Y voting stock owned by C and D together represent 30 percent of the voting power in Y. Under the provisions of § 53.4943–3 the excess business holdings of F in Y (determined without regard to section 4943(c)(4)) as of such date are, therefore, 50 percent of Y voting stock. Accordingly, since the combined holdings of F, C, and D in Y represent, on such date, more than 75 percent of the voting stock in Y, under the provisions of section 4943(c)(4)(B)(ii), all holdings of F in Y

(*i.e.*, 50 percent of Y voting stock will be treated as held by a disqualified person through May 25, 1984.

Example 5. M, a private foundation, owns on May 26, 1969, sole proprietorship S. Since, under the provisions of § 53.5954–3, M's ownership of S constitutes excess business holdings (determined without regard to section 4943(c)(4) as of May 26, 1969, and since M's interest in S is greater than 95 percent on such date, under the provisions of this paragraph a disqualified person will be treated as the owner of S for the 20-year period beginning on such date. If S is later incorporated, that percentage of the interest in S retained by M, even though less than a 95-percent interest, shall continue to be treated as held by a disqualified person through May 25, 1989.

Example 6. A and B, individuals, together own on May 26, 1969, 40 shares of voting stock in corporation X representng 40 percent of the voting power in X and 20 percent of the value of all outstanding shares of all classes of stock in X. A and B are both disqualified persons with respect to F, a private foundation, which owns no stock in X on May 26, 1969. On January 1, 1973, A and B donate the 40 shares of X voting stock held by them to F. Since F had no excess business holdings on May 26, 1969, section 4943(c)(4) does not apply. See however, section 4943(c)(6) and § 53.4943–6.

Example 7. Assume the facts as stated in Example (6), except that F, on May 26, 1969, owns 50 shares of voting stock in X, representing 50 percent of the voting power in X and 25 percent of the value of all outstanding shares of all classes of stock in X. Under the provisions of this paragraph, the 50 shares of X voting stock held by F on May 26, 1969 shall be treated in accordance with the provisions of section 4943(c)(4), while the 40 shares of X voting stock acquired by F on January 1, 1973 shall be treated in accordance with the provisions of section 4943(c)(6). See § 53.4943–6.

(d) *Permitted holdings under section* 4943(c)(4)—(1) *In general.* The permitted holdings of a private foundation to which section 4943 (c)(4) applies in a business enterprise shall be as follows:

(i) The excess of the substituted combined voting level over the disqualified person voting level, and separately,

(ii) The excess of the substituted combined value level over the disqualified person value level.

(2) *Definitions.* For purposes of paragraph (d) of this section:

(i) The term *disqualified person voting level* on any given date means the percentage of voting stock held by all disqualified persons together on such date (including stock deemed held by such a person by reason of section 4943(c)(4), (5), or (6)).

(ii) The term *disqualified person value level* on any given date means the percentage of the total value of all outstanding shares of all classes of stock in a business enterprise held by all disqualified persons together on such date (including stock deemed held by such a person by reason of section 4943(c)(4), (5), or (6)).

(iii) The term *foundation voting level* prior to the second phase is equal to zero. After the first phase, such term on any given date means the lowest percentage of voting stock held by a private foundation (without regard to section 4943(c)(4)(B)) in a business enterprise on May 26, 1969, and at all times thereafter up to such date. See section 4943(c)(5) and § 53.4943–5 for the effect of the interests acquired pursuant to the terms of certain wills or trusts in effect on May 26, 1969.

(iv) The term *foundation value level* prior to the second phase is equal to zero. After the first phase, such term on any given date means the lowest percentage of the total value of all outstanding shares of all classes of stock held by a private foundation (without regard to section 4943(c)(4)(B)) in a business enterprise on May 26, 1969, and at all times thereafter up to such date. See section 4943(c)(5) and § 53.4943–5 for the effect of interests acquired pursuant to the terms of certain wills or trusts in effect on May 26, 1969.

(v) The term *substituted combined voting level* means the lowest percentage to which the sum of the foundation voting level plus the disqualified person voting level has been reduced since May 26, 1969, by paragraph (d)(4) of this section to the following modifications (the ''downward ratchet rule''), subject;

(A) In no event shall such substituted level exceed 50 percent; and

(B) Such substituted level shall be increased (but not above 50 percent) in accordance with section 4943(c)(5) and § 53.4943–5 for certain interests acquired by such foundation pursuant to the terms of a will or trust in effect on May 26, 1969.

(vi) The term *substituted combined value level* means the lowest percentage to which the sum of the foundation value level plus the disqualified person

value level has been reduced since May 26, 1969, by paragraph (d)(4) of this section (the ''downward ratchet rule''), subject to the following modifications:

(A) In no event shall such substituted level exceed 50 percent; and

(B) Such substituted level shall be increased (but not above 50 percent) in accordance with section 4943(c)(5) and § 53.4943–5 for certain interests acquired by such foundation pursuant to the terms of a will or trust in effect on May 26, 1969.

(vii) In the case of an interest in a partnership or joint venture, definitions (i) through (iv) of this subparagraph shall be applied by substituting ''profit interests'' for ''voting stock'' and ''all partnership interests'' for ''all outstanding shares of all classes of stock.''

(viii) In the case of an interest in a business enterprise other than a corporation, partnership or joint venture, definitions (i) through (iv) of this subparagraph shall be applied by substituting ''beneficial remainder interests'' for ''voting stock'' and ''all beneficial remainder interests'' and ''all outstanding shares of all classes of stock.''

(ix) Each level defined in paragaph (d)(2)(iii), (iv) and (v) and (vi) as of any date shall be carried over to the subsequent date subject to any adjustments prescribed for such level.

(3) *Permitted holdings—First phase.* Since during the first phase the substituted combined voting level generally does not exceed the disqualified person voting level, and the substituted combined value level generally does not exceed the disqualified person value level, the permitted holdings during the first phase are generally equal to zero. The permitted holdings during the first phase exceed zero only where the 20 percent (or 35 percent) limitation on the downward ratchet rule contained in paragraph (d)(4)(ii)(B) of this section applies.

(4) *Downward ratchet rule*—(i) *In general.* Except as provided in paragraph (d)(4)(ii) of this section and section 4943(c)(5):

(A) *Scope of rule.* In general, when the percentage of the holdings in a business enterprise held by a private foundation and all disqualified persons together to which section 4943(c)(4) applies decreases, or when the percentage of the holdings of the private foundation alone in such business enterprise decreases, such holdings may not be increased (except as provided under section 4943(c) (5) or (6)). This so-called ''downward ratchet rule'' is designed to prevent the private foundation from purchasing additional holdings in the business enterprise until the substituted combined voting level reduced to the 20-percent (or 35 percent) figure prescribed by section 4943(c)(2).

(B) *Levels affected.* Under the downward ratchet rule any decrease after May 26, 1969, in the percentage of holdings comprising either the substituted combined voting level, the substituted combined value level, the foundation voting level or the foundation value level shall cause the respective level to be decreased to such decreased percentage for purposes of determining the foundation's permitted holdings.

(C) *Implementation of reductions.* Thus, if at any time the sum of the foundation voting level and the disqualified peson voting level is less than the immediately preceding substituted combined voting level, the substituted level shall be decreased so that it equals such sum. For example, if on May 26, 1969, a foundation and all disqualified persons together have holdings in a business enterprise equal to 50 percent, on such date the substituted combined voting level and the disqualified person voting level equal 50 percent (since such holdings of the foundation are treated as held by a disqualified person). If the private foundation or a disqualified person on May 27, 1969, sold 2 percent of such holdings to a nondisqualified person, the disqualified person voting level would be decreased to 48 percent (50% − 2%), causing the substituted combined voting level to be decreased to 48 percent. As a further example, assume that on May 26, 1969, a foundation and all disqualified persons together have holdings in a business enterprise equal to 50 percent, and when the first phase expires on May 26, 1979, the substituted combined voting level is still 50 percent, the foundation voting level is 10 percent, and the disqualified person voting level is 40 percent. If a disqualified person there-

after sells 2 percent to a nondisqualified person so that the sum of the disqualified person voting level (40% − 2%=38%) and the foundation voting level (10%) equals 48 percent (38%+10%), then the substituted combined voting level is decreased to 48 percent. Similarly, if at any time the sum of the foundation value level and the disqualified person value level is less than the immediately preceding substituted combined value level, the substituted combined value level shall be decreased so that it equals such sum.

(D) *Restrictions on increases in levels.* In addition, none of the four levels referred to in paragraph (d)(4)(i)(B) of this section may be adjusted upward to reflect any increase in the holdings comprising such level, except as provided in section 4943(c)(5) and § 53.4943–5. As a result, any transfer of May 26, 1969, holdings from a disqualified person to a private foundation shall not increase the foundation voting level or the foundation value level (unless the transfer qualifies under section 4943(c)(5)), and thus may reduce the substituted combined value level (and where appropriate, the substituted combined voting level). Thus, in the last preceding example, if the disqualified person, instead of selling the 2 percent interest to a nondisqualified person, had sold such interest to the foundation, the substituted combined voting level would still be reduced to 48 percent, since the disqualified person voting level would be reduced by 2 percent (to 38%) but the foundation voting level would not be increased by 2 percent (remaining at 10%). However, any transfer of May 26, 1969, holdings from a private foundation to a disqualified person under section 101(1)(2)(B) of the Tax Reform Act of 1969, shall reduce the foundation value level (and, where appropriate, the foundation voting level), but will not reduce the substituted combined value level or the subsituted combined voting level. The disqualified person voting level and disqualified person value level are correspondingly increased, not being limited to interest held since May 26, 1969. In addition, a transfer of May 26, 1969, holdings from one disqualified person to another, for example, by bequest, shall not reduce the substituted combined voting level nor the substituted combined value level.

(ii) *Exceptions*—(A) *One percent de minimus rule.* If after May 26, 1969, there are one or more decreases in the holdings comprising any of the four levels referred to in paragraph (d)(4)(i)(B) of this section during any taxable year of a private foundation, and if such decreases are attributable to issuances of stock (or such issuances coupled with redemptions), then, unless the aggregate of such decreases equals or exceeds 1 percent, the determination of whether there is a decrease in such level for purposes of this paragraph (d)(4) shall be made only at the close of such taxable year. If, however, the aggregate of such decreases equals or exceeds 1 percent, such level shall be decreased at that time as if the previous sentence has never applied.

(B) *Twenty percent (or 35 percent) floor.* In no event shall the downward rachet rule contained in paragraph (d)(4)(i) of this section decrease the substituted combined voting level or the substituted combined value level below 20 percent, or, for purposes of section 4943(c)(2)(B), below 35 percent.

(iii) *Special rules*—(A) *Change of foundation managers.* In the case of a foundation manager (as defined in section 4946(b)) who on May 26, 1969, owns holdings in a business enterprise and who is replaced by another foundation manager, the decrease in the substituted combined voting or value levels shall be limited to the excess, if any, of the departing foundation manager's holdings over his successor's holdings.

(B) *Termination of private foundation status under section 507.* If an organization gives the notification described in section 507(b)(1)(B)(ii) of the commencement of a 60-month termination period and fails to meet the requirements of section 509(a)(1), (2) or (3) for the entire period, then such organization will be treated as a private foundation during the entire 60-month period for purposes of this paragraph (d)(4) and section 4946(a)(1)(H). For example, X, a private foundation gives notification of the commencement of a 60-month termination commencing on

January 1, 1972. X and Y, another private foundation, are effectively controlled by the same persons within the meaning of section 4946(a)(1)(H). X and Y hold 25 percent each of the voting stock of Z corporation on May 26, 1969, so that the substituted combined voting level for X or Y is 50 percent on such date. If X meets the requirements of section 509(a) (1), (2), or (3) for the entire 60-month period, section 4946(a)(1)(H) is inapplicable to X, and, under the downward ratchet rule, the substituted combined voting level for Y is decreased by 25 percent. On the other hand, if X meets the requirements of section 509(a)(2) for its taxable years 1972 and 1973, but fails to meet the requirements of section 509(a) (1), (2), or (3) in 1974, 1975, and 1976, then solely for purposes of section 4943(c)(4)(A)(ii) and this paragraph (d)(4), X will be treated as a disqualified person with respect to Y, and Y will be treated as a disqualified person with respect to X, for taxable years 1972 through 1976 pursuant to section 4946(a)(1)(H). Thus, for purposes of section 4943(c)(4)(A)(ii) the substituted combined voting level for X or Y will not be decreased by reason of the fact that X was attempting to terminate under section 507(b)(1)(B), and assuming no other transportations, such level; will remain at 50 percent.

(iv) *Examples*. The provisions of this paragraph (d)(4) may be illustrated by the following examples:

Example 1. F, a private foundation, owns on May 26, 1969, 50 shares of voting stock in corporation X representing to 50 percent of the voting stock in X and 25 percent of the value of all outstanding shares of all classes of stock in X. A and B, the only disqualified persons with respect to F, together own, on such date, 2 shares of voting stock in X representing 2 percent of the voting shock in X and 1 percent of the value of all outstanding shares of all classes of stock in X. In addition, on such date, F owns 30 shares of nonvoting stock in X, representing 30 percent of the value of all outstanding shares of all classes of stock in X, and A and B together own 15 shares of nonvoting stock in X representing 15 percent of the value of all outstanding shares of classes of stock in X. The provisions of section 4943(c)(4)(B)(iii) apply and during the 10-year period beginning on May 26, 1969, a disqualified person is deemed to hold all interests of F in X. Assume that on February 1, 1972, F sells to C, unrelated in individual, 12 shares of voting stock in X representing 12 percent of the voting stock in X and 6 percent of the value of all outstanding shares of all classes of stock in X.

(i) Beginning on May 26, 1969, the disqualified person voting level is 52 percent, the foundation voting level is zero, and the substituted combined voting level is 50 percent; the disqualified person value level is 71 percent, the foundation value level is zero, and the substituted combined value level is 50 percent.

(ii) Beginning on February 1, 1972, the disqualified person voting level is 40 percent (52% − 12%), the foundation voting level is zero, and the substituted combined voting level is 40 percent; the disqualified person value level is 65 percent (71% − 6%), the foundation value level is zero and the substituted combined value level is 50 percent.

Example 2. F, a private foundation on the calendar year basis, holds, on May 26, 1969, 30 percent of the voting stock in corporation Y. C and D, the only disqualified persons with respect to F, together hold, on such date, 10 percent of the voting stock in Y. The provisions of section 4943(c)(4)(B)(iii) apply with respect to F, and disqualified persons are deemed to hold all interests of F in Y for the 10-year period beginning on May 26, 1969, so that the substituted combined voting level as of such date is 40 percent. On February 1, 1973, a stock issuance by Y causes the combined holdings of voting power by F, C, and D in Y to decrease by 0.3 percent. on June 1, 1973, another such issuance causes such combined holdings to decrease by 0.5 percent. In September 1, 1973, an unrelated stock redemption by Y causes such combined holdings to increase by 0.4 percent. Under this paragraph the determination whether there is a decrease in the substituted combined voting level for purposes of the downward ratchet rule shall not be made before January 1, 1974, since the aggregate of the decreases occurring on February 1 and June 1 of 1973 is less than 1 percent (0.3%+0.5%). Therefore, the substituted combined voting level as of January 1, 1974, is 39.6 percent (40% − [(0.3%+0.5%) − 0.4%].)

Example 3. Assume the facts as stated in Example (2), except that, on October 1, 1973, a stock issuance by Y causes the combined holdings of voting power by F, C, and D in Y to decrease by 0.3 percent. Since the aggregate of the decreases occurring on February 1, June 1, and October 1 of 1973 exceeds 1 percent, the determination whether there is a decrease in the substituted combined voting level shall be made as of October 1, 1973. At that time the substituted combined voting level shall be reduced to 39.2 percent (40% − 0.3% − 0.5%), the lowest actual combined holdings during the period that the de minimis rule was in effect.

(5) *Permitted holdings—Second phase*—(i) *In general*. For purposes of section

4943 and this section, the term ''second phase'' means the 15-year period immediately following the first phase. Upon the expiration of the first phase with respect to an interest to which section 4943(c)(4) applies, such interest shall no longer be treated as held by a disqualified person under section 4943(c)(4)(B). During the second phase, the manner of determining the permitted holdings of a private foundation to which section 4943(c)(4) applies shall be the same as applicable to the first phase, except that a 25 percent maximum shall apply under certain conditions specified in paragraph (d)(5)(ii) of this section. For these purposes the substituted combined voting level and the substituted combined value level in effect for the foundation at the end of the first phase shall be carried over to the second phase. The substituted levels are carried over because although there is a decrease in the disqualified person levels (since holdings are no longer treated as held by disqualified persons under section 4943(c)(4)(B)), a corresponding increase in the foundation levels occurs. For example, if a private foundation on May 26, 1969, held 10 percent of the voting stock in a corporation and disqualified persons held 40 percent of the voting stock, both the disqualified person voting level and the substituted combined voting level equal 50 percent (10%+40%). Assuming no transactions during the first phase, on May 26, 1979, the disqualified person voting level would be decreased to 40 percent (50% − 10%), but the foundation voting level would be increased to 10 percent so that the substituted combined voting level would remain at 50 percent. In addition, the downward ratchet rule of paragraph (d)(4) of this section shall continue to apply, to prevent the foundation and disqualified persons from purchasing any additional interest in the same enterprise until the substituted combined voting level decreases below 20 percent.

(ii) *25 percent maximum on foundation holdings.* If, or as soon as, the disqualified person voting level exceeds 2 percent after the expiration of the first phase, the permitted holdings shall not thereafter exceed 25 percent of the voting stock or 25 percent of the value of all outstanding shares of all classes of stock, even though the holdings of the foundation and all disqualified persons combined do not exceed the substituted level. Solely for purposes of determining whether the 25 percent limitation of this subdivision (ii) applies, the disqualified person voting level shall not be treated as exceeding 2 percent solely as a result of the holdings of a private foundation which are treated as held by a disqualified person by reason of section 4943(c) (5) or (6). For example, where under the constructive ownership rules for trusts in § 53.4943–8(b), a private foundation is deemed to own more than 2 percent of the voting stock of a business enterprise but such stock is treated as held by a disqualified person under section 4943(c)(5), the determination of the substituted percentage for permitted holdings in the second phase will be as if the foundation owned the stock held by the trust. Similarly, where a private foundation is the only remainder beneficiary of a trust that is a disqualified person under section 4946(a)(1)(H), the disqualified person voting level shall not be treated as exceeding 2 percent solely as a result of the holdings of such a trust.

(6) *Permitted holdings—Third phase.* For purposes of section 4943 and this section, the term ''third phase'' means the entire period following the second phase. During the third phase the manner of determining the permitted holdings of a private foundation to which section 4943(c)(4) applies shall be the same as applicable to the second phase under paragraph (d)(5) of this section (including the carryover of levels from the earlier phase). However, if the 25 percent limit of paragraph (d)(5)(ii) of this section never applied during the second phase, the substituted combined voting level and the substituted combined value level each shall not exceed 35 percent during the third phase.

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

Example 1. F, a private foundation, owns on May 26, 1969, 30 shares of voting stock in corporation Z representing 30 percent of the voting power in Z and 15 percent of the value of all outstanding shares of all classes of stock in Z, and owns, on such date, 10 shares of nonvoting stock in Z representing 10 percent of the value of all outstanding shares of

all classes of stock in Z. E and G, the only disqualified persons with respect to F, own, on such date, 5 shares each of nonvoting stock in Z. The 10 shares of nonvoting stock in Z owned by E and G together represent 10 percent of the value of all outstanding shares of all classes of stock in Z. Assume further that F cannot meet the requirements for the 35 percent test of section 4943(c)(2)(B). For purposes of applying section 4943(c)(4)(B) and this paragraph, F has excess business holdings in Z (determined without regard to section 4943(c)(4)), because under section 4943(c)(2)(A) F's permitted holdings are 20 percent (20% − 0%) of the voting stock since disqualified persons have no holdings of voting stock. Therefore, section 4943(c)(4)(B) and this paragraph apply, and a disqualified person is treated as holding F's shares of both voting and nonvoting stock in Z for the 10-year period through May 25, 1979. Thus, since all holdings by F in Z are treated as held by a disqualified person during the first phase, F cannot be subject to tax under section 4943(a) on its May 26, 1969, holdings prior to the termination of the first phase, regardless of whether or not disqualified persons purchase additional shares of Z during the first phase.

Example 2. Assume the same facts as in Example (1), and further assume that there were no transactions in the stock of Z during the first phase (May 26, 1969 through May 25, 1979). During the first phase the permitted holdings by F in Z for both the voting stock and the value is zero. The disqualified person voting level and the substituted combined voting level are each 30 percent, and the disqualified person value level and the substituted combined value level are each 35 percent (15%+10%+10%). The substituted levels are carried over into the second phase. The disqualified person voting level on May 26, 1979, the beginning of the second phase, is zero, because the voting shares held by F are no longer treated as held by a disqualified person. Therefore, F's permitted holdings on such date are 30 percent of the voting stock, because such percentage is equal to the excess of the substituted combined voting level (30%) over the disqualified person voting level (0%). The disqualified person value level on May 26, 1979, is 10 percent, because the voting and nonvoting shares held by F are no longer treated as held by a disqualified person. Therefore, F's permitted holdings on such date are 25 percent of the value of Z stock, because such percentage is equal to the excess of the substituted combined value level (35%) over the disqualified person value level (10%) as of such date.

Example 3. Assume the facts as stated in Example (2), except that E and G acquire, on February 1, 1970, 10 shares of Z voting stock representing 10 percent of the voting power in Z and 5 percent of the value of all outstanding shares of all classes of stock in Z. During the first phase such permitted holdings remain zero, and prior to May 25, 1979, the substituted combined voting level and substituted combined value level remain 30 and 35 percent, respectively, because such levels may not be increased by acquisitions by disqualified persons. However, the disqualified person voting level and the disqualified person value level are each increased to 40 percent (30%+10%) and 40 percent (35%+5%) respectively. During the first phase the excess of the disqualified person voting level over the substituted combined voting level (40% − 30%) and the excess of the disqualified person value level over the substituted combined value level (40% − 35%) indicate how much stock F must dispose of during the first phase to avoid the initial tax when it expires. On May 25, 1979, the last day of the first phase, F disposes of 12 shares of Z voting stock, representing 12 percent of the voting power in Z and 6 percent of the value of all such outstanding shares. The disposition by F reduces the interest F owns to 18 percent (30% − 12%) of the voting power, and 19 percent (25% − 6%) of the value of all outstanding shares of all classes of stock, in Z. Since the disqualified person voting level decreases to 28 percent (40% − 12%), the substituted combined voting level as of May 25, 1979, accordingly is decreased to 28 percent under the downward ratchet rule. Similarly, the substituted combined value level is decreased to 34 percent, as the disqualified person value level as of such date is 34 percent (40% − 6%). On May 26, 1979, the disqualified person voting level is 10 percent (28% − 18%), and the disqualified person value level is 15 percent (34% − 19%), since the shares owned by F are no longer treated as held by a disqualified person as of such date. Accordingly, on May 26, 1979, the permitted holdings by F and Z are 18 percent of the voting power in Z, because such percentage is equal to the excess of the substituted combined voting level (28%) over the disqualified person voting level (10%) as of such date. Similarly, the permitted holdings of F in Z by value are 19 percent (34% − 15%). If F had not disposed of the 12 shares, then on May 26, 1979, F's permitted holdings in voting power and value would be 20 percent (30% − 10%) and 20 percent (35% − 15%), respectively.

Example 4. F, a private foundation, owns on May 26, 1969, 35 shares of voting stock in corporation Y representing 35 percent of the voting stock in Y and 17.5 percent of the value of all classes of stock in Y, and owns on such date 45 shares of nonvoting stock representing 22.5 percent of the value of all outstanding shares of all classes of stock in Y. No disqualified person with respect to F owns, on such date, any stock in Y. Assume further that Y cannot meet the requirements of the 35 percent test of section 4943(c)(2)(B). For purposes of applying section 4943(c)(4)(B) and this paragraph, F has excess business

holdings in Y (determined without regard to section 4943(c)(4)), because under section 4943(c)(2)(A) F's permitted holdings are 20 percent (20% − 0%) of the voting stock since disqualified persons have no holdings of voting stock. Therefore, section 4943(c)(4)(B) and this paragraph apply, and a disqualified person is treated as holding F's shares of both voting and nonvoting stock in Y for the 10-year period through May 25, 1979. During the first phase the permitted holdings by F in Y of both the voting stock and of value are zero. The disqualified person voting level and the substituted combined voting level are each 35 percent, and the disqualified person value level and the substituted combined value level are each 40 percent (17.5%+22.5%). The substituted levels are carried over into the second phase. The disqualified person voting level and value level on May 26, 1979, are both zero, because the shares held by F are no longer treated as held by a disqualified person. Therefore, F's permitted holdings on such date are 35 percent of the voting power (35% − 0%) and 40 percent of the value (40% − 0%). Assume that on February 1, 1981, A, a disqualified person, acquires 6 percent of the voting stock in Y representing 3 percent of the value of all outstanding shares of all classes of stock in Y. The permitted holdings by F in Z on February 1, 1981, are thus reduced to 25 percent of the voting stock (the lesser of the separate 25% second phase limitation or 29% (35% substituted combined voting level minus 6% disqualified person voting level)) and 25 percent of the value (the lesser of the separate 25% second phase limitation or 37% (40% substituted combined value level minus 3% disqualified person value level)). But see paragraph (d)(8) of this section for limitations on restrictions with respect to nonvoting stock.

Example 5. Assume the same facts as in Example (4) except that A does not acquire the 6 shares of voting stock until February 1, 1996 (in the third phase), rather than on February 1, 1981. Thus, F's permitted holdings in Y would remain at 35 percent of the voting stock and 40 percent of the value during the second phase, which expired on May 25, 1994. Assume that on May 25, 1994, the last day of the second phase, F disposes of 10 shares of nonvoting stock representing 5 percent of the value of all outstanding shares in Y to meet the 35 percent third phase limit. In accordance with the downward ratchet rule, the substituted combined value level and F's permitted holdings in Y would be reduced to 35 percent of value. On February 1, 1996, F's permitted holdings in Y would be reduced to 25 percent of the voting stock (the lesser of the separate 25% third phase limitation or 29% (35% substituted combined voting level minus 6% disqualified person level)) and 25 percent of the value (the lesser of the separate 25% third phase limitation or 32% (35% substituted combined value level minus 3% disqualified person value level)). But see paragraph (d)(8) of this section for limitations on restrictions with respect to nonvoting stock.

(8) *Special rule where all holdings are permitted under section 4943(c)(2).* (i) Since section 4943(c)(4) and this paragraph provide transitional rules for foundations which would otherwise have had excess business holdings on May 26, 1969, no holdings shall cease to be permitted holdings under this paragraph where such holdings would be permitted holdings under section 4943(c)(2) and § 53.4943–3. Thus, for example, where the substituted combined voting level had been reduced to 20 percent, the provisions of § 53.4943–3(b)(2) concerning nonvoting stock as permitted holdings generally apply.

(ii) The provisions of this paragraph (d)(8) may be illustrated by the following example:

Example. (A) F, a private foundation, owns, on May 26, 1969, 40 shares of voting stock in corporation X representing 40 percent of the voting stock in X and 20 percent of the value of all outstanding shares of all classes of stock in X, and owns, on such date, 60 shares of nonvoting stock in X, representing 30 percent of the value of all outstanding shares of all classes of stock in X. A, the only disqualified person with respect to F, owns, on such date, 10 shares of voting stock in X, representing 10 percent of the voting stock in X and 5 percent of the value of all outstanding shares of all classes of stock in X. Under section 4943(c)(4)(B)(iii), a disqualified person is deemed the owner of all holdings by F in X for the 10–year period beginning on May 26, 1969.

(B) Assume that the only transaction in X stock during the first phase is the disposition of 30 shares of voting stock by F on May 1, 1975. The voting stock held by F is permitted holdings under § 53.4943–3 and under such section since all disqualified persons together do not own more than 20 percent of the voting stock in X, all nonvoting stock held by F shall also be treated as permitted holdings. Therefore, all the stock held by F is permitted holdings.

(C) Assume that on May 1, 1975, F had disposed of only 15 shares of voting stock and also had disposed of 35 shares of nonvoting stock. On May 26, 1979, at the beginning of the second phase, this paragraph (d)(8) would not apply since F would have excess business holdings under § 53.4943–3. Under the provisions of this section, the permitted holdings by F in X on such date are 25 percent of the

voting stock (35% substituted combined voting level minus 10% disqualified person voting level) and 25 percent of the value (30% substituted combined value level minus 5% disqualified person value level).

(9) *Special rule for certain private foundations.* In the case of a private foundation:

(i) Which was incorporated before January 1, 1951.

(ii) Substantially all of the assets of which on May 26, 1969, consisted of more than 90 percent of the stock of an incorporated business enterprise which is licensed and regulated, the sales or contracts of which are regulated, and the professional representatives of which are licensed, by State regulatory agencies in at least 10 States;

(iii) Which acquired such stock solely by gift, devise, or bequest;

(iv) Which does not purchase any stock or other interest in such enterprise after May 26, 1969, and does not acquire any stock or other interest in any other business enterprise which constitutes excess business holdings under § 53.4943–3; and

(v) Which, in the last 5 taxable years ending on or before December 31, 1970, expended substantially all of its adjusted net income (as defined in section 4942(f)) for the purpose or function for which it is organized and operated;

paragraph (d) (1) through (5) of this section (permitted holdings during the first and second phase) shall be applied with respect to the holdings of such foundation in such incorporated business enterprise by substituting ''51 percent'' for ''50 percent,'' and section 4943(c)(4)(D) (third phase) shall not apply with respect to such holdings. For purposes of the preceding sentence, stock of such enterprise in a trust created before May 27, 1969, of which the foundation is the remainder beneficiary shall be deemed to be held by such foundation on May 26, 1969, if such foundation held (without regard to such trust) more than 20 percent of the stock of such enterprise on May 26, 1969.

(10) *Special rule for changes in the relative values of stock of different classes.* (i) In the case of a corporation that has more than one class of stock outstanding, if the percentage of value held by the private foundation, its disqualified persons, or both, increases over a period of time solely as a result of changes in the relative values of the stock of different classes, then the foundation value level, the disqualified person value level, and the substituted combined value level, as defined in paragraph (d)(2) of this section, shall be adjusted to reflect such increase. An increase in the percentage of value held shall not be considered to have occurred solely as a result of changes in the relative values of the stock of different classes if:

(A) There has been any increase during the period in the percentage of any class of stock held by the private foundation, its disqualified persons, or both, or

(B) There has been any issuance, redemption, or purchase by the issuing corporation of any stock during the period.

See § 53.4943–6(d) for rules relating to increases caused by readjustments.

(ii) *Example.* The provisions of this paragraph (b)(10) may be illustrated by the following example:

Example. (i) At all times since May 26, 1969, F, a private foundation, has held 25% (500,000 shares) of the outstanding class of voting stock of X corporation. No disqualified person with respect to F holds any voting stock of X. In addition X has had outstanding since May 26, 1969, a class of non-voting preferred stock, none of which is held by F or a disqualified person. X is an active business corporation and third parties do not have effective control of X. On May 26, 1969, the voting stock (2 million shares outstanding) was trading for $5 a share on the New York Stock Exchange. The non-voting preferred stock, not publicly traded, was valued at $1 million. The total value of all outstanding stock was $11 million ($10 million voting stock plus $1 million non-voting preferred). On May 26, 1969, F held 22.73% of the value of X's outstanding stock ($2.5 million/$11 million).

(ii) On October 31, 1982, X's voting stock is trading for $20 a share and the nonvoting stock is valued at $3 million. At all times during the period May 26, 1969, through October 31, 1982, F has held 25 percent of the voting stock and none of the nonvoting stock of X. No stock of X is owned by disqualified persons. No stock of X has been issued, redeemed or purchased by X during this period. On October 13, 1982, the total value of X's outstanding stock (is $43 million ($40 million voting stock and $3 million nonvoting stock) and F holds 23.26 percent of the value of X's outstanding stock ($10 million/$43 million).

F's foundation value level and the substituted combined value level are increased from 22.73 percent to 23.26 percent to reflect this change.

(iii) On November 1, 1982, X corporation distributes the stock of Y corporation, a wholly-owned subsidiary, to X's shareholders. Y is a business enterprise. Under this paragraph (d)(10), all of F's stock in X is permitted holdings under section 4943 (c)(4) even though the percentage of value held by F has increased from 22.73 percent on May 26, 1969, to 23.26 percent on November 1, 1982. F's permitted holdings in Y will be determined by reference to F's permitted holdings in X under § 53.4943–7. Therefore, assuming no prohibited transaction occurs, F's permitted holdings in Y stock equal 25 percent of Y's voting stock and, separately, 23.26 percent of the value of all of Y's outstanding stock.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6478, Feb. 22, 1984]

§ 53.4943–5 Present holdings acquired by trust or a will.

(a) *Interests to which section 4943(c)(5) applies—(1) In general.* Section 4943(c)(5) provides that section 4943(c)(4) (other than the 20-year first phase holding period) applies to an interest in a business enterprise acquired after May 26, 1969 by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before May 26, 1969, which were in effect on May 26, 1969, and at all times thereafter, as if such interest were held on May 26, 1969. However the first phase holding period prescribed by § 53.4943–4(c)(1) (ii) or (iii) shall commence for such an interest on the date of distribution to the foundation. Unlike section 4943(c)(4) and § 53.4943–4, section 4943(c)(5) and this section treat only the interest so acquired (and not the entire interest held by the foundation in such enterprise on the date of distribution) as held by a disqualified person during a first phase holding period. (See, however, section 4943(c)(6) and paragraph (b)(2) of § 53.4943–6 for the treatment of other holdings of the foundation in the same enterprise if an interest to which section 4943(c)(5) applies is acquired from a person who was not a disqualified person prior to the acquisition.) In addition, section 4943(c)(5) and this section shall not apply if after the acquisition of such an interest the foundation would not have excess business holdings (determined without regard to section 4943(c) (4), (5), or (6)).

(2) *After-acquired interests.* Section 4943(c)(5) and this section shall not apply to any interest acquired after May 26, 1969, by an estate or trust, other than by reason of the death of the decedent. For example, where a foundation is a residuary beneficiary under the terms of a will executed before May 26, 1969, and the residue of the estate consists of cash, then stock subsequently purchased with cash for distribution to the foundation will not be treated as an interest acquired under the terms of a will executed on or before May 26, 1969.

(3) *Certain revocable trusts.* If an interest in a business enterprise actually passes to a private foundation under a trust which would have met the tests referred to in paragraph (a)(1) of this section but for the fact that the trust was revocable (even though it was not in fact revoked) and such interest would have passed to such foundation under a will that meets those tests but for the fact that the grantor died without having revoked the trust, then for purposes of section 4943(c)(5) and this section, such an interest shall be treated as having been acquired by the foundation under the will.

(4) *Modification of will*—(i) *In general.* For purposes of section 4943(c)(5) and this section, an amendment or republication of a will which was executed on or before May 26, 1969, does not prevent any interest in a business enterprise which was to pass under the terms (which were in effect on May 26, 1969, and at all times there- after) of such will from being treated as a present holding under section 4943(c) (4) or (5):

(A) Solely because there is a reduction in the interest in the business enterprise which the foundation was to receive under the terms of the will (for example, if the foundation is to receive the residuary estate, and if one class of stock is disposed of by the decedent during his lifetime or by a subsequent codicil);

(B) Solely because such amendment or republication is necessary in order to comply with section 508(e) and the regulations thereunder;

(C) Solely because there is a change in the executor of the will; or

(D) Solely because of any other change which does not otherwise change the rights of the foundation with respect to such interest in the business enterprise.

However, if under such amendment or republication there is an increase in the interest in the business enterprise which the foundation was to receive under the terms of the will in effect on May 26, 1969, such increase shall not be treated as present holdings under section 4943(c) (4) or (5). Under such circumstances the interest which would have been acquired before such increase shall remain present holdings. See section 4943(c)(6) and § 53.4943–6 with respect to the treatment of such increase in holdings of a private foundation.

(ii) *Examples*. The provisions of this paragraph (a)(4) may be illustrated by the following examples:

Example 1. On May 9, 1985, A modifies by codicil his will which was in effect on May 26, 1969, and was unchanged until such modification. The purpose of the codicil was, in the event of A's death, to increase the number of shares in X Corporation that would pass to the W foundation from 70 percent of all the voting power and value to 80 percent. Under these facts, if A dies without further modifying the terms of the will which apply to W's interest in X, section 4943(c)(5) will apply to 70 percent of the X voting power and value and section 4943(c)(6) will apply to 10 percent of the X voting power and value, since 10 percent of the X voting power and value would not pass under a provision of the will which was in effect on May 26, 1969, and at all times thereafter. Accordingly, if the stock is distributed to W on July 6, 1988, then, assuming that on May 26, 1969, W and all disqualified persons owned less than 75% of the voting stock in X, an amount of such stock representing 70 percent of X voting power and value shall be treated as held by a disqualified person through July 5, 1998, and an amount of such stock representing 10 percent of X voting power and value shall be treated as held by a disqualified person through July 5, 1993.

Example 2. Assume the facts as stated in Example (1), except that the sole purpose of the codicil was to change the executor of the will. Under paragraph (a)(4)(i) of this section, such codicil will not prevent the X voting stock which was bequeathed to W from being treated as held by a disqualified person through July 5, 1998.

(b) *Holding periods*—(1) *In general*. An interest to which section 4943(c)(5) applies shall be entitled to a 15-year holding period starting on the date of distribution only if the interests actually or constructively owned by a private foundation and all disqualified persons on May 26, 1969, in a business enterprise exceed 75 percent of the voting stock (or of the profits or beneficial interest) or 75 percent of the value of all outstanding shares of all classes of stock (or of the profits and capital interest) in such enterprise. For purposes of the preceding sentence, interests held by the foundation on May 26, 1969, shall be deemed to include an interest to which section 4943(c)(5) applies and which has been acquired (on or before the date of distribution for the interest in question) from a person who was not a disqualified person on May 26, 1969. Therefore, if under the terms of a will in effect on May 26, 1969, and at all times thereafter, a private foundation is created on July 1, 1975, and receives 76 percent of the voting stock of a business enterprise on that date, such stock shall be treated as held by a disqualified person until June 30, 1990. Any interest to which section 4943(c)(5) applies but which is not entitled to a 15-year holding period shall be entitled to a 10-year holding period starting on the date of distribution. For purposes of this paragraph the date of distribution shall be deemed to occur no later than the date on which the trust or estate is considered to be terminated under § 1.641(b)–(3) of this chapter (Income Tax Regulations).

(2) *Constructive ownership prior to date of distribution*. To the extent that an interest to which section 4943(c)(5) applies is constructively held by a private foundation under section 4943(d)(1) and § 53.4943–8 prior to the date of distribution, it shall be treated as held by a disqualified person prior to such date by reason of section 4943(c)(5). In addition, in the case of a foundation's interest in a trust which was irrevocable on May 26, 1969, and to which both sections 4943 (c)(4) and (c)(5) apply, the first phase holding period for such interest shall end with whichever such period under section 4943(c) (4) or (5) ends later. For example, if under the terms of such a trust, 96 percent of the

voting stock in a business enterprise was constructively held by a private foundation on May 26, 1969, and was distributed to such foundation on June 30, 1970, such interest is entitled to a 20-year holding period beginning on May 26, 1969.

(c) *Permitted holdings*—(1) *In general.* The permitted holdings of a private foundation which has an interest in a business enterprise to which section 4943(c)(5) applies shall be determined in accordance with the rules of paragraph (d) of § 53.4943–4. The levels referred to in such paragraph shall be adjusted to take into account the acquisition of such an interest as if it were treated as held by a disqualified person from May 26, 1969, until the date of acquisition. See also § 53.4943–6(b)(2) for the special rule for interests held by a private foundation at the time it acquires a section 4943(c)(5) interest from a nondisqualified person. Thus, for example, if on June 30, 1975, the disqualified person voting level and the substituted combined voting level in corporation X with respect to foundation F are 45 percent, and a nondisqualified person's 10 percent voting interest in X is acquired by F on July 1, 1975, in a transaction to which section 4943(c)(5) applies, the above-mentioned levels shall be increased to 55 and 50 percent respectively, on July 1, 1975. However, if such interest had been acquired from a person who was a disqualified person on May 26, 1969, rather than from a nondisqualified person, no adjustments in such levels would have taken place on July 1, 1975. In such a case, though, at the beginning of the second phase on July 1, 1985, the foundation voting level would be increased by 10 percent, and the disqualified person voting level decreased by 10 percent (assuming that none of the acquired stock had been disposed of prior to such date).

(2) *Separate phases.* The phases for each interest to which section 4943(c)(5) applies start independently from those for any other interest of the foundation in the same enterprise to which section 4943(c) (4) or (5) applies. Therefore, until an interest enters its own second phase, the 25 percent limit described in paragraph (d)(5) of § 53.4943–4 shall not apply to such interest (and any subsequently acquired section 4943(c)(5) interest in the first phase) is still treated as held by a disqualified person for purposes of that 25 percent limit. In addition, if such an interest enters its second phase and at such time all disqualified persons together do not have holdings in excess of 2 percent of the voting stock in the same business enterprise, then the 25 percent limit of section 4943(c)(4)(D)(i) shall not then apply to such interest, even though such limit may have been applicable to an interest with an earlier second phase. Moreover, the 35 percent limit of section 4943(c)(4)(D)(ii) shall cause only interests which have entered the third phase to become excess business holdings, taking into account, however, interests in prior phases in determining the holdings subject to such limit.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples: (After each example is a chart setting forth the chronological changes in the various levels referred to in paragraph (d) of § 53.4943–4.)

Example 1. On May 26, 1969, F, a private foundation, owns no stock in M Corporation, and A, a disqualified person owns 40 percent of the voting stock (voting power and value) in M. A dies on May 1, 1971, leaving 30 percent of the voting stock in M to F and leaving the other 10 percent to a disqualified person. Distribution is made on June 1, 1972, and assume that section 4943(c)(5) applies. No transactions in the stock of M, other than those described in this example, occur. On May 26, 1969, the substituted combined voting level is 40 percent, the disqualified person voting level is deemed to be 40 percent, and the permitted holdings by F in M is deemed to be 0 percent (40% − 40%). On May 1, 1971 (the date that F acquired the M stock by reason of its constructive ownership of A's estate), the various levels remain unchanged. On May 1, 1971, the 30 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On June 1, 1981, F disposes of 6 percent of the voting stock to a nondisqualified person. The substituted combined voting level and the disqualified person voting level thereby are reduced to 34 percent (40% − 6%) each. On June 1, 1982, at the beginning of the second phase, the foundation voting level increases to 24 percent (30% − 6%) and the disqualified person voting level is reduced to 10 percent (34% − 10%). The substituted combined voting level as of June 1, 1982, remains at 34 percent. The permitted holdings as of such date are 24 percent (34% − 10%). If F had not disposed of any holdings prior to June 1, 1982,

F's permitted holdings would have been 25 percent, the lesser of 25 percent (the limitation of section 4943(c)(4)(D)(i)), or 30 percent (40% – 10%). Since on such date the 30 percent interest would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 5 percent (30% – 25%).

Date	F owns (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969	0	0	40	0	40	40	0	
May 1, 1971	*+30*	*+30*	*– 30*	.....	.....	.....	.....	A dies.
Do	30	30	10	0	40	40	0	
June 1, 1972	30	30	10	0	40	40	0	Distribution.
June 1, 1981	*– 6*	*– 6*	.....	.....	*– 6*	*– 6*	.....	F sells 6 pct.
Do	24	24	10	0	34	34	0	
June 1, 1982	.....	*– 24*	.....	*+24*	.....	*– 24*	*+24*	2d phase begins.
Do	24	0	10	24	34	10	24	

Example 2. (i) On May 26, 1969, F, a private foundation, owns 30 percent of the voting stock of N Corporation (voting power and value) and disqualified persons own 20 percent of the voting stock of N Corporation. On May 1, 1971, B, a disqualified person, dies leaving 15 percent of the voting stock to F. Assume the distribution was made on June 1, 1972, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting levels are each 50 percent and the permitted holdings are 0 percent (50% – 50%). On May 1, 1971, and June 1, 1972, these levels remain unchanged. On May 1, 1971, the 15 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982.

(ii) On July 1, 1978, F sells 6 percent of the F stock to a nondisqualified person, thereby reducing the disqualified person voting level and the substituted combined voting level to 44 percent (50% – 6%). On May 26, 1979, at the beginning of the second phase for F's 1969 holdings, the foundation voting level is 24 percent (30% – 6%), the substituted combined voting level is still 44 percent, and the disqualified person voting level is 20 percent (44% – 24%). The permitted holdings are 24 percent (44% – 20%). In addition F's 24 percent holdings do not exceed the 25 percent limitation of section 4943(c)(4)(D)(i) and paragraph (d)(5)(ii) of § 53.4943–4.

(iii) On August 1, 1981, F sells 16 percent of the N stock to a nondisqualified person, thereby reducing the foundation voting level to 8 percent (24% – 16%), and reducing the substituted combined voting level to 28 percent (44% – 16%). The disqualified person voting level remains at 20 percent. On June 1, 1982, at the beginning of the second phase for F's holdings acquired by will, the substituted combined voting level is still 28 percent, the foundation voting level is 23 percent (8%+15%), the disqualified person voting level is 5 percent (20% – 15%), and the permitted holdings are 23 percent (28% – 5%).

(iv) If F had not disposed of the 6 percent on July 1, 1978, then on May 26, 1979, at the beginning of the second phase for F's 1969 holdings, F's permitted holdings would have been 25 percent, the lesser of 25 percent (the limitation of section 4943(c)(4)(D)(i), or 30 percent (50% – 20%). Since F's 30 percent interest would no longer have been treated as held by a disqualified person on May 26, 1979, F would have had excess business holdings of 5 percent (30% – 25%). Similarly, if F had not disposed of the 16 percent interest on August 1, 1981 (but had disposed of the 6 percent interest), on July 1, 1982, at the beginning of the second phase for F's holdings acquired by will, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943(c)(4)(D)(i)), or 39 percent (44% – 5%). Since as of such date F's entire holdings of 39 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 14 percent (39% – 25%).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	30	30	.....	30	20	0	50	50	0	

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 1, 1971	*+15*	.....	*+15*	*+15*	*−15*	.....	.....	.....	.....	B dies.
Do	45	30	15	45	5	0	50	50	0	
June 1, 1972.	45	30	15	45	5	0	50	50	0	Distribution.
July 1, 1978	*−6*	*−6*	.....	*−6*	.....	.....	*−6*	*−6*	.....	F sells 6 pct.
Do	39	24	15	39	5	0	44	44	0	
May 16, 1979.	.....	.....	.....	*−24*	.....	*+24*	.....	*−24*	*+24*	2d phase for 24 pct.
Do	39	24	15	15	5	24	44	20	24	
Aug. 1, 1981.	*−16*	*−16*	.....	.....	.....	*−16*	*−16*	.....	*−16*	F sells 16 pct.
D0	23	8	15	15	5	8	28	20	8	
July 1, 1982	.....	.....	.....	*−15*	.....	*+15*	.....	*−15*	*+15*	All in 2d phase.
Do	23	8	15	0	5	23	28	5	23	

Example. (3). (i) On May 26, 1969, F, a private foundation owns 5 percent of the voting stock of O Corporation (voting power and value), and disqualified persons own 45 percent of the voting stock. C, a disqualified person, dies on May 1, 1971, and leaves 41 percent of the voting stock of O to F. Assume that distribution is made on June 1, 1972, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, the various levels remain unchanged. On May 1, 1971, the 41 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On May 26, 1979, at the beginning of the second phase for F's 1969 holdings of 5 percent, the 5 percent is no longer treated as held by a disqualified person, the foundation voting level is 5 percent, the disqualified person voting level is reduced to 45 percent (50% − 5%), and the substituted combined voting level remains at 50 percent. On such date F's permitted holdings are 5 percent (50% − 45%). Since the 41 percent interest is treated as held by a disqualified person, the interest treated as held by F (5%) does not exceed the 25 percent limitation of section 4943(c)(4)(D)(i).

(ii) On August 1, 1981, F sells 22 percent of the O stock to a nondisqualified person, thereby reducing the foundation voting level to 0 percent. Since the reductions are first applied to the 1969 holdings of 5 percent, 17 percent (22% − 5%) applies to the 41 percent interest, reducing such interest to 24 percent (41% − 17%), and reducing the disqualified person voting level to 28 percent (45% − 17%). The substituted combined voting level is reduced to 28 percent (0%+28%). On June 1, 1982, at the beginning of the second phase for F's holdings acquired by will, the substituted combined voting level remains at 28 percent, the foundation voting level is 24 percent, the disqualified person voting level is reduced to 4 percent (28% − 4%).

(iii) If F had not disposed of the 22 percent interest prior to June 1, 1982, F's permitted holdings would have been 25 percent, the lesser of 25 percent, (under section 4943(c)(4)(D)(i)), or 46 percent (50% − 4%). Since as of such date, F's entire holdings of 46 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 21 percent (46% − 25%).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	5	5	.....	5	45	0	50	50	0	
May 1, 1971	*+41*	.....	*+41*	*+41*	*−41*	.....	.....	.....	.....	C dies.
Do	46	5	41	46	4	0	50	50	0	
June 1, 1972.	46	5	41	46	4	0	50	50	0	Distribution.

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1979.	.....	.....	.....	*−5*	.....	*+5*	.....	*−5*	*+5*	2d phase for 5 pct.
Do	46	5	41	41	4	5	50	45	5	
Aug. 1, 1981.	*−22*	*−5*	*−17*	*−17*	.....	*−5*	*−22*	*−17*	*−5*	F sells 22 pct.
Do	24	0	24	24	4	0	28	28	0	
June 1, 1982.	.....	.....	.....	*−24*	.....	*+24*	.....	*−24*	*+24*	2d phase for 24 pct.
Do	24	0	24	0	4	24	28	4	24	

Example 4. (i) On May 26, 1969, F, a private foundation, owns 30 percent of the voting stock in P Corporation (voting power and value), and disqualified persons own 20 percent. On May 1, 1971, D, a disqualified person, dies leaving 18 percent of the voting stock to F. Assume that distribution was made on June 1, 1972, and that section 4943 (c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are each 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, these levels remain unchanged. On May 1, 1971, the 18 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On May 26, 1979, the foundation voting level increases to 30 percent, the disqualified person voting level decreases to 20 percent (50% − 30%), and the permitted holdings are 30 percent (50% − 20%). On June 1, 1982, the foundation voting level increases to 48 percent, the disqualified person voting level decreases to 2 percent and the permitted holdings are 48 percent (50% − 2%). Since at no time during the second phase for F's 1969 holdings did all disqualified persons together have holdings in excess of 2 percent of the voting stock of P, the 25 percent limitation of section 4943(c)(4)(D)(i) did not apply to F's 1969 holdings.

(ii) On July 1, 1993, F disposes of 16 percent of the stock in P, thereby reducing the substituted combined voting level to 34 percent (50% − 16%), and reducing the permitted holdings to 32 percent (34% − 2%). If F had not disposed of the 16 percent of the stock of P prior to May 26, 1994, on such date, under section 4943(c)(4)(D)(ii), F's substituted combined voting level for its 1969 holdings would have been 35 percent, and the permitted holdings would have been 33 percent (35% − 2%). Since none of F's holdings of 48 percent would have been treated as held by a disqualified person on such date (the beginning of the third phase for F's 1969 holdings), F would have had excess business holdings of 15 percent, the lesser of 30 percent (F's 1969 holdings in the third phase), of 15 percent (the excess of F's 48 percent holdings over the permitted holdings of 33 percent).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	30	30	.....	30	20	0	50	50	0	
May 1, 1971	*+18*	.....	*+18*	*+18*	*−18*	.....	.....	.....	.....	D dies.
Do	48	30	18	48	2	0	50	50	0	
June 1, 1972.	48	30	18	48	2	0	50	50	0	Distribution.
May 26, 1979.	.....	.....	.....	*−30*	.....	*+30*	.....	*−30*	*+30*	2d phase for 30 pct.
Do	48	30	18	18	2	30	50	20	30	
June 1, 1982.	.....	.....	.....	*−18*	.....	*+18*	.....	*−18*	*+18*	2d phase for 18 pct.
Do	48	30	18	0	2	48	50	2	48	
July 1, 1993	*−16*	*−16*	.....	.....	.....	*−16*	*−16*	.....	*−16*	F disposes of 16 pct.
Do	32	14	18	0	2	32	34	2	32	

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1994.	32	14	18	0	2	32	34	2	32	3d phase for 14 pct.
June 1, 1997.	32	14	18	0	2	32	34	2	32	3d phase for 18 pct.

Example 5. (i) On May 26, 1969, F, a private foundation, owns 5 percent of the voting stock in Q Corporation (voting power and value), and disqualified persons own 45 percent. On May 1, 1971, E, a disqualified person, dies leaving 43 percent of the voting stock to F. Assume that distribution was made on June 2, 1972, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are each 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, these levels remain unchanged. On May 1, 1971, the 43 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On May 26, 1979, the foundation voting level increases to 5 percent, the disqualified person voting level decreases to 45 percent, and the permitted holdings are 5 percent (50% − 45%). On June 1, 1982, the foundation voting level increases to 48 percent, the disqualified person voting level decreases to 2 percent, and the permitted holdings are 48 percent (50% − 2%). At no time during the second phase for F's 1969 holdings did all disqualified persons together have holdings in excess of 2 percent of the voting stock of Q. Therefore, the 25 percent limitation of section 4943(c)(4)(D)(i) did not apply.

(ii) On July 1, 1993, F sells 6 percent of the stock in Q to a nondisqualified person. This reduces the substituted combined voting level to 44 percent and reduces the permitted holdings to 42 percent (44% − 2%). If F had not disposed of the 6 percent of the stock in 1993, on May 26, 1994, at the beginning of the third phase for F's 1969 holdings, F would have had 5 percent excess business holdings. The excess business holdings are 5 percent because although the excess business holdings computed for the third phase are 15 percent (the excess of F's actual holdings (48%) over the permitted holdings of 33 percent (35% − 2%)), only 5 percent of the holdings are in this phase and subject to the 35 percent combined holdings limitation.

(iii) On July 1, 1995, F sells 10 percent of the stock in Q, thereby reducing the substituted combined voting level to 34 percent and reducing the permitted holdings to 32 percent (34% − 2%). If F had not disposed of the 10 percent of the stock, on June 1, 1997, at the beginning of the third phase for F's acquired holdings, F would have had 9 percent excess business holdings (the excess of F's total holdings in the third phase (42%) over the permitted holdings of 33 percent (35% − 2%)).

Date	F's owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	5	5	.....	5	45	0	50	50	0	
May 1, 1971	*+43*	.....	*+43*	*+43*	*−43*	.....	.....	.....	.....	E dies.
Do	48	5	43	48	2	0	50	50	0	
June 1, 1972.	48	5	43	48	2	0	50	50	0	Distribution.
May 26, 1979.	.....	.....	.....	*−5*	.....	*+5*	.....	*−5*	*+5*	2d phase for 5 pct
Do	48	5	43	43	2	5	50	45	5	
June 1, 1982.	.....	.....	.....	*−43*	.....	*+43*	.....	*−43*	*+43*	2d phase for 43 pct.
Do	48	5	43	0	2	48	50	2	43	
July 1, 1993	*−6*	*−5*	*−1*	.....	.....	*−6*	*−6*	.....	*−6*	F sells 6 pct.
Do	42	0	42	0	2	42	44	2	42	
July 1, 1995	*−10*	.....	*−10*	.....	.....	*−10*	*−10*	.....	*−10*	F sells 10 pct.

Date	F's owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
Do	32	0	32	0	2	32	34	2	32	
June 1, 1997.	32	0	32	0	2	32	34	2	32	3d phase for 32 pct.

Example 6. (i) On May 26, 1969, F, a private foundation, owns 30 percent of the voting stock in R Corporation (voting power and value), and disqualified persons own 20 percent. On August 1, 1978, F disposes of 6 percent of the stock to a nondisqualified person. On May 1, 1981, G, a disqualified person, dies leaving 15 percent of the voting stock to F. Assume that distribution was made on June 1, 1982, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are each 50 percent, and the permitted holdings are 0 percent (50% − 50%). On August 1, 1978, these levels decrease to 44 percent (50% − 6%). On May 26, 1979, the foundation voting level increases to 24 percent (30% − 6%), the disqualified person voting level decreases to 20 percent (44% − 24%), and the permitted holdings are 24 percent (44% − 20%). If F had not disposed of the 6 percent of the stock prior to May 26, 1979, on May 26, 1979, the beginning of the second phase for F's 1969 holdings, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943(c)(4)(D)(i)) or 30 percent (50% − 20%). Since the 30 percent interest would no longer have been treated as held by a disqualified person on such date, F would have had excess business holdings of 5 percent (30% − 25%).

(ii) On May 1, 1981, and June 1, 1982 (assuming F had disposed of the 6 percent holdings), the foundation voting level, the disqualified person voting level, the substituted combined voting level and permitted holdings remain respectively 24 percent, 20 percent, 44 percent and 24 percent. On May 1, 1981, the 15 percent interest is treated as held by a disqualified person for a period extending through May 31, 1992. On July 1, 1991, F sells 16 percent of the voting stock in R to a nondisqualified person, thereby reducing the substituted combined voting level to 28 percent (44% − 16%), and reducing the foundation voting level to 8 percent (24% − 16%). The disqualified person voting level remains at 20 percent. On June 1, 1992, at the beginning of the second phase for F's holdings acquired by will, the substituted combined voting level remains at 28 percent, the foundation voting level increases to 23 percent (8%+15%) and the disqualified person voting level decreases to 5 percent (20% − 15%). The permitted holdings on such date are 23 percent (28% − 5%). If F had not disposed of the 16 percent interest prior to June 1, 1992, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943 (c)(4)(D)(i)) or 39 percent (44% − 5%). Since as of such date, F's entire holdings of 39 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 14 percent (39% − 25%).

Date	F's owns (percent)	F's interest 1969 (percent)	F's interest 1981 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969	30	30	.....	30	20	0	50	50	0	
Aug. 1, 1978	*− 6*	*− 6*	.....	*− 6*	.....	.....	*− 6*	*− 6*	.....	F disposes of 6 pct.
Do	24	24	.....	24	20	0	44	44	0	
May 26, 1979	.....	.....	.....	*− 24*	.....	*+24*	.....	*− 24*	*+24*	2d phase for 24 pct.
Do	24	24	.....	0	20	24	44	20	24	
May 1, 1981	*+15*	.....	*+15*	*+15*	*− 15*	.....	.....	.....	.....	G dies.
Do	39	24	15	15	5	24	44	20	24	
June 1, 1982	39	24	15	15	5	24	44	20	24	Distribution.
July 1, 1991	*− 16*	*− 16*	.....	.....	.....	*− 16*	*− 16*	.....	*− 16*	F disposes of 16 pct.
Do	23	8	15	15	5	8	28	20	8	

Date	F's owns (percent)	F's interest 1969 (percent)	F's interest 1981 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
June 1, 1992	.....	.....	.....	*−15*	.....	*+15*	.....	*−15*	*+15*	2d phase for 15 pct.
Do	23	8	15	0	5	23	28	5	23	

Example 7. (i) On May 26, 1969, F, a private foundation, owns 5 percent of the voting stock in S Corporation (voting power and value), and disqualified persons own 45 percent. On May 1, 1980, H, a disqualified person, dies leaving 41 percent of the voting stock to F. Assume that distribution is made on June 1, 1981, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and disqualified person voting levels are each 50 percent. On May 26, 1979, the disqualified person voting level decreases to 45 percent, the foundation voting level increases to 5 percent, and the permitted holdings are 5 percent (50% − 45%). On May 1, 1980, and June 1, 1981, the levels remain the same. Since the 41 percent holdings are treated as held by a disqualified person for the period beginning on May 1, 1980, and extending through May 31, 1991, F's remaining holdings of 5 percent do not exceed the 25 percent limitation of section 4943(c)(4)(D)(i).

(ii) On August 1, 1990, F sells 22 percent of the voting stock of S to a nondisqualified person, reducing the 5 percent foundation voting level to zero, leaving 17 percent (22% − 5%) to reduce the disqualified person voting level to 28 percent (45% − 17%) so that the substituted combined voting level equals 28 percent (50% − 22%). On June 1, 1991, the beginning of the second phase for the remaining 24 percent (41% − 17%) of F's holdings acquired by will, the foundation voting level increases from zero to 24 percent, the disqualified person voting level decreases to 4 percent (28% − 24%), the substituted combined voting level remains at 28 percent, and the permitted holdings equal 24 percent (28% − 4%).

(iii) If F had not disposed of the 22 percent holdings prior to June 1, 1991, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943(c)(4)(D)(i)) or 46 percent (50% − 4%). Since as of such date, F's entire holdings of 46 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 21 percent (46% − 25%).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1980 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent	Comments
May 26, 1969.	5	5	.....	5	45	0	50	50	0	
Do	.....	.....	.....	*−5*	.....	*+5*	.....	*−5*	*+5*	2d phase for 5 pct.
May 26, 1969.	5	5	.....	0	45	5	50	45	5	
May 1, 1980	*+41*	.....	*+41*	*+41*	*−41*	.....	.....	.....	.....	H dies.
Do	46	5	41	41	4	5	50	45	5	
June 1, 1981.	46	5	41	41	4	5	50	45	5	Distribution.
Aug. 1, 1990.	*−22*	*−5*	*−17*	*−17*	.....	*−5*	*−22*	*−17*	*−5*	F disposes of 22 pct.
Do	24	0	24	24	4	0	28	28	0	
June 1, 1991.	.....	.....	.....	*−24*	.....	*+24*	.....	*−24*	*+24*	2d phase for 24 pct.
Do	24	0	24	0	4	24	28	4	24	

§ 53.4943–6 Five-year period to dispose of gifts, bequests, etc.

(a) *In general*—(1) *Application*. (i) Paragraph (6) of section 4943(c) prescribes transition rules for a private foundation, which, but for such paragraph, would have excess business holdings as a result of a change in the holdings in a business enterprise after May 26, 1969 (other than by purchase by such private foundation or by a disqualified person) to the extent that section 4943(c)(5) (relating to certain holdings acquired under a pre-May 27, 1969, will on trust) does not apply.

(ii) Subparagraph (A) of section 4943(c)(6) applies where, immediately prior to a change in holdings described in paragraph (a)(1)(i) of this section, the foundation has no excess business holdings in such enterprise (determined without regard to section 4943(c) (4), (5), or (6)). In such a case, the entire interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than by the foundation) during the five-year period beginning on the date of such change.

(iii) Subparagraph (B) of section 4943(c)(6) applies where the foundation has excess business holdings in such enterprise (determined without regard to section 4943(c) (4), (5), or (6)) immediately prior to a change in holdings described in paragraph (a)(1)(i) of this section. In such a case, the interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than the foundation) during the five-year period beginning on the date of such change, except that if and as soon as any holdings in such enterprise become excess business holdings during such period (determined without regard to such change (and the resulting application of section 4943(c)(6) to the foundation's interest in such enterprise)), such holdings shall no longer be treated as held by a disqualified person under this section, but shall constitute excess business holdings subject to the initial tax. In applying the preceding sentence, if holdings of the foundation which (but for such change in holdings (and the resulting application of section 4943(c)(6) to the foundation's interest in such enterprise)) would be subject to the 25 percent limit prescribed by section 4943(c)(4)(D) after the expiration of the first phase, such holdings shall be treated as subject to such percentage limitation for purposes of determining excess business holdings. For example, if a private foundation in 1978 has present holdings of 28 percent in a busines enterprise to which section 4943(c)(4) applies, and such holdings would exceed the 25 percent limit of section 4943(c)(4)(D)(i) on May 26, 1979, a gift of 5 percent to the foundation in 1978 of an interest in such enterprise shall not prevent the 3 percent (28% − 25%) excess over the 25 percent limit from constituting excess business holdings on May 26, 1979, if on such date disqualified persons hold more than a 2 percent interest in such enterprise (and no other transaction has taken place).

(2) *Acquisitions that are not purchases*. Section 4943(c)(6) does not apply if a change in holdings in a business enterprise is the result of a purchase by the private foundation or a disqualified person. For purposes of subparagraph (a) of this paragraph, the term ''purchase'' shall not include any acquisition by gift, devise, bequest, legacy, or interstate succession. Paragraph (d) of this section provides rules for the treatment of increases in holdings received in a readjustment (as defined in § 53.4943–7(d)(1)).

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

Example 1. On January 4, 1985, A, an individual, makes a contribution to F, a private foundation, of 200 shares of X Corporation common stock. Assume that F had no X stock before January 4, 1985, and under section 4943(c)(1) the receipt of the X stock by F would cause some or all of the 200 shares of the X stock to be classified as excess business holdings. Under the provisions of section 4943(c)(6)(A) and this paragraph (a), since the contribution of the X stock to F is a gift and not a purchase, the X stock in F's hands is treated as held by disqualified persons and not by F through January 3, 1990.

Example 2. Assume the facts as stated in Example (1) except that F receives the X stock as a bequest pursuant to the terms of A's will executed on April 1, 1980. A dies on June 3, 1984, and the stock is distributed to F on February 16, 1985. As in Example (1), the

bequest of X to F is not a purchase under this paragraph (a). Consequently, the X stock in F's hands is treated as held by disqualified persons and not by F through February 15, 1990.

Example 3. On February 1, 1980, F, a private foundation, owns 15 percent of the voting stock of X Corporation, and disqualified persons own 4 percent of the voting stock of X Corporation. On February 2, 1980, B, a nondisqualified person, contributes 8 percent of the voting stock of X to F in a transaction to which section 4943(c)(5) does not apply. Assuming that the 35 percent limit of section 4943(c)(2)(B) does not apply, under the provisions of section 4943(c)(6)(A) and paragraph (a) of this section the 23 percent voting stock owned by F on such date is treated as held by a disqualified person through February 1, 1985, since F would have had excess business holdings of 7 percent as a result of the contribution (23% actual holdings less 16% (20% − 4%) permitted holdings). On March 1, 1984, C, another nondisqualified person, contributes 6 percent of the voting stock of X Corporation to F. But for this second contribution and the resulting application of section 4943(c)(6) to F's interest in X, F would have excess business holdings of 7 percent (23% − 16%) within the five-year period beginning on the date of such contribution. Accordingly, under section 4943(c)(6)(B) and paragraph (a) of this section, all 29 percent (6%+23%) of the stock held by F on March 1, 1984, will be treated as held by a disqualified person until March 1, 1989, except that 7 percent will cease to be so treated on February 2, 1985. If prior to February 2, 1985, no further transactions occurred in the stock of X, F would have excess business holdings of 7 percent subject to the initial tax, since the amount still treated as held by disqualified persons (29% − 7%) plus the amount actually held by disqualified persons (4%) already exceed 20 percent.

(b) *Special rules for acquisitions by will or trust*—(1) *In general.* In the case of an acquisition of holdings in a business enterprise by a private foundation pursuant to the terms of a will or trust, the five-year period described in section 4943(c)(6) and in this section shall not commence until the date on which the distribution of such holdings from the estate or trust to the foundation occurs. See § 53.4943–5(b)(1) for rules relating to the determination of the date of distribution under the terms of a will or trust. For purposes of this subparagraph, holdings in a business enterprise will not be treated as acquired by a private foundation pursuant to the terms of a will where the holdings in the business enterprise were not held by the decedent. Thus, in the case of after-acquired property, this subparagraph shall not apply, the five-year period described in section 4943(c)(6) and this section shall commence on the date of acquisition of such holdings by the estate, and such five-year period may expire prior to the date of distribution of such holdings from the estate. To the extent that an interest to which section 4943(c)(6) and this paragraph (b)(1) apply is constructively held by a private foundation under section 4943(d)(1) and § 53.4943–8 prior to the date of distribution, it shall be treated as held by a disqualified person prior to such date by reason of section 4943(c)(6). See § 53.4943–8 for rules relating to constructive holdings held in an estate or trust for the benefit of the foundation.

(2) *Special rule for section 4943(c)(5) interests acquired from a nondisqualified person.* (i) In the case of holdings of a private foundation in a business enterprise to which section 4943(c)(5) (relating to certain holdings acquired under a pre-May 27, 1969, will or trust) applies which are acquired from a nondisqualified person, the interest of the foundation in such enterprise (immediately after such acquisition) shall (while held by the foundation) be treated as held by a disqualified person (rather than the foundation) under section 4943(c)(6)(B) and paragraph (a)(1)(iii) of this section from the date of acquisition until the end of the fifth year following the date of distribution of such holdings. Thereafter, only the holdings to which section 4943(c)(5) and § 53.4943–5(a)(1) apply shall continue to be treated as held by a disqualified person until the end of the first phase with respect thereto.

(ii) The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following examples:

Example 1. On May 26, 1969, F, a private foundation, owns 5 percent of the voting stock of Corporation X and no disqualified persons own any stock in X. On June 30, 1977, a nondisqualified person bequeaths to F 33 percent of the voting stock in X to which section 4943(c)(5) applies. This 33 percent interest is distributed to F on August 17, 1978. Under section 4943(c)(6)(A) the entire 38 percent (5%+33%) of the X voting stock shall be treated as held by a disqualified person from June 30, 1977 (the date the 33 percent interest

is contructively acquired by F) until August 17, 1983 (five years after the date of distribution of the 33 percent interest to F). However, assuming that the 35 percent limit of section 4943(c)(2)(B) does not apply, the substituted combined voting level on June 30, 1977 is only 33 percent because there was no interest to which section 4943(c) (4) or (5) applied immediately before that date and thus there was no substituted combined voting level at that time. In that case, since the 3-phase holding period is only available for the interest acquired by will (33%) under section 4943(c)(5), the substituted combined voting level on June 30, 1977 is only 33 percent, not 38 percent. Assuming that the substituted combined voting level remains 33 percent at all relevant times, and prior to August 17, 1983, no further transactions occur in the stock of X, F on that date would have excess business holdings of 5 percent subject to the initial tax. The amount treated as held by disqualified persons at that time (33%) would equal the substituted combined voting level at that time (33%), and thus permitted holdings would be zero. Under section 4943(c)(5) the 33 percent interest will continue to be treated as held by a disqualified person until August 17, 1988 (10 years after the date of distribution).

Example 2. On May 26, 1969, F, a private foundation, owns 29 percent of the stock (voting power and value) of Corporation X, and on June 30, 1977, a nondisqualified person bequeaths to F 23 percent of the stock (voting power and value) in X to which section 4943(c)(5) does apply. This 23 percent interest is distributed to F on August 17, 1978. Disqualified persons hold no stock of X. Although the substituted combined voting and value levels cannot exceed 50 percent on May 26, 1979 (at the start of the second phase with respect to the 29 percent interest), under section 4943(c)(6)(B) the entire 52 percent (29%+23%) of the X voting stock shall be treated as held by a disqualified person from June 30, 1977 (the date the 23% interest is constructively acquired by F) until August 17, 1983 (five years after the date of distribution of the 23% interest to F). On June 1, 1980, during such second phase, D, a disqualified person, purchases 3 percent of the X stock (voting power and value). On such date, but for the acquisition by F of the 23 percent interest, F would have had excess business holdings of 4 percent. The purchase by D of more than 2 percent of the voting stock of X causes the 25 percent limit of section 4943(c)(4)(D)(i) to apply to the 29 percent interest (29% − 25%=4%). Thus, on June 1, 1980, 4 percent of the X voting stock held by F since May 27, 1969, shall cease to be treated as held by a disqualified person under section 4943(c)(6)(B) and become excess business holdings subject to the initial tax. See § 53.4943–2(a)(1)(ii) for the 90-day period in which to dispose of these excess business holdings resulting from the purchase by the disqualified person.

(c) *Exceptions.* (1) Section 4943(c)(6) and this section shall not apply to any transfer of holdings in a business enterprise by one private foundation to another private foundation which is related to the first foundation within the meaning of section 4946(a)(1)(H).

(2) Section 4943(c)(6) and this section shall not apply to an increase in the holdings of a private foundation in a business enterprise that is part of a plan whereby disqualified persons will purchase additional holdings in the same enterprise during the five-year period beginning on the date of such change, e.g., to maintain control of such enterprise, since such increase shall be treated as caused in part by the purchase of such additional holdings.

(3) The purchase of holdings by an entity whose holdings are treated as constructively owned by a foundation, its disqualified persons, or both, under section 4943(d)(1) shall be treated as a purchase by a disqualified person if the foundation, its disqualified persons or both have effective control of the entity or otherwise can control the purchase. For example, if a foundation is the beneficiary of a specific bequest of $20,000 and its consent is required for the estate to make a purchase using such cash, then a purchase by the estate using such cash would be treated as a purchase by a disqualified person. Similarly, if an executor of an estate is a disqualified person with respect to a private foundation, any purchase by the estate would be treated as a purchase by a disqualified person.

(4) If a private foundation, its disqualified persons, or both, hold an interest in specific property under the terms of a will or trust, and if the private foundation, its disqualified persons, or both, consent or otherwise agree to the substitution of holdings in a business enterprise for such specific property, such holdings shall be treated as acquired by purchase by a disqualified person. For example, if a private foundation is the beneficiary of a specific bequest of $20,000 and the private foundation agrees to accept certain of the estate's holdings in a business enterprise in satisfaction of such

specific bequest, such holdings will be treated as acquired by purchase by a disqualified person even if such holdings were held by the decedent.

(d) *Readjustments and distributions*—(1) *General rule*. Except as otherwise provided in subparagraph (2) of this paragraph, any increase in holdings in a business enterprise that is the result of a readjustment (as defined in § 53.4943–7(d)(1)) shall be treated as acquired other than by purchase. However, holdings that are attributable to holdings owned by the private foundation that would have been excess business holdings except for the fact that such holdings were treated as held by a disqualified person prior to the readjustment shall in no event be treated as held by a disqualified person after the date on which the holdings to which the change is attributable would have ceased to be treated as held by a disqualified person.

(2) *Exceptions*. Any increase in holdings in a business enterprise that is the result of a readjustment (as defined in § 53.4943–7(d)(1)), including any change resulting from application of the rule in § 53.4943–8(c)(3), shall be treated as occurring by purchase by a disqualified person:

(i) To the extent the increase is attributable to holdings that were excess business holdings prior to the readjustment, and separately

(ii) To the full extent of the increase if the readjustment includes a prohibited transaction, unless the foundation establishes to the satisfaction of the Commissoner that effective control of all parties to the transaction was, at the time of the transaction, in one or more persons (other than the foundation) who are not disqualified persons with respect to the foundation. See § 53.4943–7(d)(2) for the definition of prohibited transaction.

(3) *Section 4943(c)(6) holdings*. If, immediately prior to a readjustment (as defined in § 53.4943–7(d)(1)), a private foundation has holdings in a business enterprise that are treated under section 4943(c)(6) as held by a disqualified person, then any holdings in a business enterprise that are received in the readjustment in exchange for such section 4943(c)(6) holdings shall be treated as the holdings surrendered in the exchange to the same extent as provided in § 53.4943–7 with respect to exchanges involving holdings to which section 4943(c) (4) or (5) applies. Rules similar to those in § 53.4943–7(a)(2) shall be applied to determine when holdings are treated as surrendered or received in a readjustment for purposes of this paragraph.

(4) *Redemption by a corporation that is a disqualified person*. If a foundation holds an interest in a corporation that is a disqualified person, an increase in the holdings of the private foundation, its disqualified person, or both, as a result of a redemption or a purchase of stock of the disqualified person corporation by such corporation shall not be treated as acquired by purchase by a disqualified person based solely on the status of the corporation as a disqualified person.

(5) *One percent rule for redemptions*. If the holdings of a foundation, its disqualified persons, or both, in a business enterprise are increased as a result of one or more redemptions during any taxable year then, unless the aggregate of such increases equals or exceeds one percent of the outstanding voting stock or one percent of the value of all outstanding shares of all classes of stock, the determination of whether such increases cause the foundation to have excess business holdings shall be made only at the close of the private foundation's taxable year. The five-year period described in section 4943(c)(6) or the 90-day period described in § 53.4943–2(a)(1)(ii), whichever is applicable, shall begin on the last day of such taxable year. If, however, the aggregate of such increases equals or exceeds one percent of the outstanding voting stock or one percent of the value of all outstanding shares of all classes of stock, the determination of whether such increases cause the foundation to have excess business holdings shall be made, and the applicable five-year or 90-day period shall begin, as of the date the increases, in the aggregate, equal or exceed one percent.

(6) *Examples*. The provisions of this paragraph are illustrated in § 53.4943–7(f) and by the following examples:

Example 1. (i) F, a private foundation, holds 20% of the voting stock of X corporation, an active business enterprise. No disqualified

person with respect to F holds any X stock. In 1980, X redeems 10% of its outstanding shares, increasing F's holdings to 22% of the X stock. Assume the redemption by X is not a prohibited transaction.

(ii) All of F's holdings before the redemption are permitted holdings under section 4943(c)(2). There is no effective control of X by third parties so the 35% permitted holdings rule is inapplicable. F's holdings after the redemption exceed the permitted holdings under section 4943 (c)(2) (20%). Because the increase is attributable to stock that was permitted holdings prior to the readjustment, and the readjustment does not involve a prohibited transaction, the 2% increase in F's holdings of X stock is treated as acquired other than by purchase. Therefore, under section 4943(c)(6) and this section, F will have 5 years from the date of the redemption to dispose of the 2% excess.

Example 2. (i) Assume the same facts as in *Example (1)* except that the 20% of X stock held by F was donated by X corporation, was worth more than $5,000 and represented 20% of the contributions received by the foundation through the end of the taxable year in which the gift of stock was made.

(ii) X corporation is a disqualified person with respect to F under section 4946(a)(1)(A). Under subparagraph (4), the redemption of X stock is not treated as a purchase by a disqualified person merely because X is a disqualified person with respect to F. Therefore the rules of this paragraph apply as if the redemption were made by a corporation which is not a disqualified person. The analysis and result are the same as in *Example (1)*.

Example 3. (i) On May 1, 1990, F, a private foundation, received a donation of 40% of the stock of X corporation, a business enterprise. Neither F nor any disqualified person with respect to F holds any other interest in X. On June 1, 1992, the X corporation redeemed F's 40% interest in exchange for 100% of the stock of Y corporation, a wholly-owned subsidiary of X. Assume the redemption by X is not a prohibited transaction.

(ii) Under section 4943(c)(6), the X stock acquired by gift is treated as held by disqualified persons through April 30, 1995. Under subparagraph (3) of this paragraph (d), 40% of the 100% interest in Y received in exchange for F's 40% interest in X is treated as F's 40% interest in X and is therefore treated as held by disqualified persons through April 30, 1995. In addition, under subparagraph (1) of this paragraph (d), the 60% interest in Y that represents an increase in holdings above the 40% held before the readjustment will be treated as acquired other than by purchase. However, F's 20% interest in X in excess of 20% permitted holdings under 4943(c)(2) would have been excess business holdings if such interest had not been treated as held by as disqualified person on June 1, 1992. Therefore, to the extent of a 30% interest in Y, (*i.e.* , the portion of the increased holdings in *Y* attributable to F's 20% holdings in X) the increased holdings will be treated as held by disqualified person only through April 30, 1995, since this is the latest date on which F's original 40% interest in X would have been treated as held by disqualified persons. The remaining 30% interest in Y will be treated as held by disqualified persons for five years from the date of the exchange (through May 31, 1997).

(e) *Constructive holdings.* Any change in holdings in a business enterprise that occurs because a corporation ceases to be actively engaged in a trade or business, thus causing its holdings to be constructively owned by its shareholders, shall be treated as acquired other than by purchase.

(f) *Certain transactions treated as purchases; cross references.* For the application of section 4943(c)(6) to holdings that were not an interest in a business enterprise when acquired but that subsequently become holdings in a business enterprise, see § 53.4943–10(d)(2).

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6479, Feb. 22, 1984]

§ 53.4943–7 Special rules for readjustments involving grandfathered holdings.

(a) *General rules*—(1) *Readjustments.* Except to the extent provided in paragraph (b) of this section, if a private foundation, its disqualified persons, or both together have holdings in a corporation to which section 4943(c) (4) or (5) applies, stock of a corporation received by the foundation, its disqualified persons, or both together in a readjustment (as defined in paragraph (d)(1) of this section) in exchange for such holdings to which section 4943 (c) (4) or (5) applies shall be treated, for purposes of section 4943 (c) (4) or (5), as the stock surrendered in the exchange.

(2) *No exchange necessary.* Paragraph (a)(1) of this section shall apply to all readjustments even if no exchange occurs. For purposes of this section, all stock held (directly or indirectly) before a readjustment in any corporation involved in the readjustment shall be treated as stock surrendered in the readjustment and all stock held (directly or indirectly) after the readjustment in

any corporation involved in the readjustment shall be treated as stock received in the readjustment in exchange for the stock treated as surrendered.

(b) *Exceptions and limitations*—(1) *Limitation on increases in percentage of voting stock.* (i) If the percentage of voting stock in a business enterprise owned (directly or indirectly) by a private foundation by reason of its ownership of stock received in an exchange described in paragraph (a) of this section exceeds the greatest percentage of voting stock in any business enterprise owned (directly or indirectly) by the private foundation prior to such exchange by reason of its ownership of the stock surrendered by it in the exchange, then:

(A) That portion of the stock received by the private foundation in the exchange which represents such excess is to be treated as an increase in the holdings of the private foundation in accordance with § 53.4943–6 (d), and

(B) Only the remaining portion of the stock received by the private foundation in the exchange shall be treated as the stock surrendered by the private foundation in the exchange.

(ii) If the sum of the percentage of voting stock in a business enterprise owned (directly or indirectly) by disqualified persons by reason of their ownership of stock received in an exchange described in paragraph (a) of this section plus the percentage of voting stock in the business enterprise owned (directly or indirectly) by the private foundation by reason of its ownership of stock received in the exchange and treated as the stock surrendered under paragraph (b) (1) (i) of this section exceeds the greatest percentage of voting stock in any business enterprise owned (directly or indirectly) by the private foundation and its disqualified person in combination by reason of their ownership of the stock surrendered by them in the exchange, then:

(A) That portion of the stock received by the disqualified persons in the exchange which represents such excess is to be treated as an increase in the holdings of the disqualified persons in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the disqualified persons in the exchange is to be treated as the stock surrendered by the disqualified persons in the exchange.

(2) *Limitation on increase in percentage of value.* (i) If the percentage of value of all outstanding shares of all classes of stock in a business enterprise owned (directly or indirectly) by a private foundation by reason of its ownership of stock received in an exhange described in paragraph (a) of this section exceeds the greatest percentage of such value in any business enterprise owned (directly or indirectly) by the private foundation prior to such exchange by reason of its ownership of the stock surrendered by it in the exchange, then:

(A) That portion of the stock received by the private foundation in the exchange which represents such excess is to be treated as an increase in the holdings of the private foundation in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the private foundation in the exchange shall be treated as the stock surrendered by the private foundation in the exchange.

(ii) If the sum of the percentage of value of all outstanding shares of all classes of stock in a business enterprise owned (directly or indirectly) by disqualified persons by reason of their ownership of stock received in an exchange described in paragraph (a) of this section plus the percentage of such value in the business enterprise owned (directly or indirectly) by the private foundation by reason of its ownership of stock received in the exchange and treated as the stock surrendered under paragraph (b)(2)(i) of this section exceeds the greatest percentage of such value in any business enterprise owned (directly or indirectly) by the private foundation and its disqualified persons in combination prior to the exchange by reason of their ownership of the stock surrendered by them in the exchange, then:

(A) That portion of the stock received by the disqualified persons in the exchange which represents such excess is to be treated as an increase in the holdings of the disqualified persons in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the disqualified persons in the exchange is to be treated as

the stock surrendered by the disqualified persons in the exchange.

(3) *Increases in percentage of both voting stock and value.* (i) If, as the result of an exchange described in paragraph (a) of this section, a private foundation has excesses determined under both paragraphs (b)(1)(i) and (b)(2)(i) of this section, then:

(A) That portion of the stock received by the private foundation in the exchange that represents the larger excess is to be treated as an increase in the holdings of the private foundation in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the private foundation in the exchange is to be treated as the stock surrendered by the private foundation in the exchange.

(ii) If as the result of an exchange described in paragraph (a) of this section, disqualified persons have excesses determined under both paragraphs (b)(1)(ii) and (b)(2)(ii) of this section, then:

(A) That portion of the stock received by the disqualified persons in the exchange that represents the larger excess is to be treated as an increase in the holdings of the disqualified persons in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by disqualified persons in the exchange is to be treated as the stock surrendered by disqualified persons in the exchange.

(4) *Exception for prohibited transactions.* If a readjustment includes a prohibited transaction, as defined in paragraph (d)(2) of this section, then this paragraph shall be applied substituting, for purposes of paragraph (b)(1) and (b)(2), the lowest percentage of voting power or value owned prior to the exchange in any business enterprise involved in the readjustment to which the exchange relates for the greatest percentage of voting power or value in any business enterprise owned by reason of ownership of the stock surrendered in the exchange.

(5) *Voting and value levels.* After an exchange described in paragraph (a) of this section, the private foundation voting and value levels, and the substituted combined voting and value levels (as defined in § 53.4943–4(d)(2)) shall be the lesser of each respective level immediately prior to the exchange with respect to the stock surrendered in the exchange and each such respective level determined immediately after the exchange by taking into account only the stock received in the exchange that is treated under this paragraph as the stock surrendered in the exchange. If the stock of more than one corporation is surrendered in exchange for stock of one corporation, the highest of each voting or value level determined immediately prior to the exchange with respect to the stock of the corporations surrendered in the exchange shall be treated as such level immediately prior to the exchange.

(6) *Determination of phases*—(i) *In general.* Stock received in an exchange described in paragraph (a) of this section that is treated as stock surrendered in the exchange under this paragraph shall be treated as subject to the same first, second, and third phases that were applicable to the stock surrendered for it. For purposes of determining the applicable phases, stock received in an exchange shall be treated as received in exchange for particular holdings of stock surrendered based on the terms of the exchange. Where only a portion of the stock received is treated as the stock surrendered, such portion of the stock received shall be treated as exchanged for particular holdings of stock surrendered in the same proportions as the total stock received was exchanged for particular holdings of stock surrendered. For example, if 20 shares of X stock owned by a private foundation, subject to a first phase beginning on January 1, 1978 and ending on December 31, 1987, are exchanged for 20 shares of Y stock, and 40 shares of X stock owned by the private foundation, subject to a first phase beginning on June 1, 1980 and ending on May 31, 1990, are exchanged for 40 shares of Y stock, then ⅓ of the Y stock received by the private foundation is treated as received in exchanged for X stock having the January 1, 1978–December 31, 1987 first phase and ⅔ of the Y stock received by the private foundation is treated as received in exchange for the X stock having the June 1, 1980–May 31, 1990 first phase. If only 30 shares of the Y stock received by the private foundation are treated as the

stock surrendered, then ⅓ (10 Y shares) will be subject to the January 1, 1978–December 31, 1987 first phase and ⅔ (20 Y shares) will be subject to the June 1, 1980–May 31, 1990 first phase.

(ii) *Transitional rule.* In any case in which holdings subject to section 4943(c)(4) or 4943(c)(5) have been consolidated prior to May 22, 1984, then the longest first phase applicable to any of the holdings surrendered in the consolidation shall be applied to the holdings received by the foundation in the consolidation that are treated as the holdings surrendered in the consolidation. For purposes of this clause, a consolidation is any readjustment that results in a reduction in the number of entities in which the foundation has direct holdings.

(c) *Plan to dispose of excess business holdings.* (1) Notwithstanding § 53.4943–4(d)(i)(4)(D) (relating to restrictions on increases in levels) and paragraphs (a) and (b) of this section, if a readjustment occurs under an approved plan to dispose of stock to which section 4943(c) (4) or (5) applies, in order to meet the requirements of section 4943(c)(4) (*i.e.*, to meet the reduced limits that will be applicable after the first phase holding period described in § 53.4943–4(c)) or to meet the requirements of section 4943(c)(2), all of the stock received in the readjustment shall be treated as held by disqualified persons through the end of the longest first phase holding period applicable to stock surrendered in the readjustment. The foundation and substituted combined voting and value levels shall not be increased on account of the readjustment.

(2) For purposes of this paragraph, a plan is an approved plan only if it is approved by the Commissioner and may be subject to such conditions as the Commissioner determines. A plan must be approved prior to any exchange or distribution pursuant to the plan except for a showing of good cause such as a business emergency.

(d) *Definitions*—(1) *Readjustments.* For purposes of this section, the term ''readjustment'' includes, but is not limited to:

(i) A merger or consolidation;

(ii) A recapitalization;

(iii) An acquisition of stock or assets;

(iv) A transfer of assets;

(v) A change in identity, form, or place of organization, however effected;

(vi) A redemption;

(vii) A distribution of assets or of stock, including a distribution to which section 301, 302, 331, or 355 applies or a distribution of stock of the distributing corporation.

(2) *Prohibited transaction.* A prohibited transaction is any transaction involving a private foundation that has holdings in a business enterprise which:

(i) Acquires stock (or similar interest in the case of an unincorporated entity) or assets of a business enterprise or redeems its own stock (or similar interest in the case of an unincorporated entity) using cash or other property transferred to the acquiring business enterprise (e.g., as a contribution to capital) by the private foundation, its disqualified persons, or both;

(ii) Acquires stock (or similar interest in the case of an unincorporated entity) or assets of a business enterprise or redeems its own stock (or similar interest in the case of an unincorporated entity) using the proceeds of a loan made to, or guaranteed by, the private foundation, its disqualified persons, or both;

(iii) Acquires 40 percent or more of the voting stock (or similar interest in the case of an unincorporated entity), 40 percent or more of the value of all outstanding shares of all classes of stock (or similar interest in the case of an unincorporated entity), or 40 percent or more of the assets of a business enterprise if the acquiring business enterprise's net assets used in its trade or business prior to such acquisition are insubstantial when compared to the net assets acquired or when compared to the net assets of the business enterprise, the stock (or similar interest in the case of an unincorporated entity) of which was acquired. For this purpose, an insubstantial ratio means a ratio that is 15% or less; or

(iv) Is used as a device to acquire or expand excess business holdings. The determination of whether a business enterprise is used as a device to acquire or expand excess business holdings shall be determined based on all the

facts and circumstances. A business enterprise shall be presumed to have been used as a device to acquire or expand excess business holdings if it acquires 40 percent or more of the voting stock (or similar interest in the case of an unincorporated entity), 40 percent or more of the value of all outstanding shares of all classes of stock (or similar interest in the case of an unincorporated entity), or 40 percent or more of the assets of a business enterprise if the consideration for the acquisition consists primarily of nonvoting stock (or similar interest in the case of an unincorporated entity) of the acquiring business enterprise.

(3) *Corporation involved in a readjustment.* A corporation shall be treated as involved in a readjustment if, as part of the readjustment, any stock of the corporation is issued or redeemed, or any stock or assets of the corporation are distributed, exchanged, purchased, sold, acquired, or otherwise transferred.

(e) *Application to unincorporated business enterprise.* The rules of this section shall apply equally to partnerships and other unincorporated business enterprises, applying the rules and substitutions provided in § 53.4943–3(c)(2), (3), and (4).

(f) *Examples.* The provisions of this section and § 53.4943–6(d) are illustrated by the following examples, which assume no prohibited transactions are involved unless otherwise stated:

Example 1. (i) F, a private foundation, has owned 80% of the one outstanding class of stock of X corporation since 1965. The X is subject to section 4943(c)(4) with a first phase ending on May 25, 1984. On January 1, 1982, X merges with Y corporation to form Z corporation. X, Y, and Z are active business corporations. F owns no Y stock. No disqualified person with respect to F owns any stock in Y.Y, or Z. After the merger, F owns 25% of the one outstanding class of Z stock. Third parties do not control Z so that the 35% permitted holdings rule under section 4943(c)(2) is inapplicable

(ii) F's percentage of voting power and value in Z after the merger (25%) are less than F's percentages of voting power and value in X before the merger (80%). Therefore, under paragraph (a)(1) of this section, all of F's holdings in Z are treated as the X stock surrendered. Therefore, the Z stock is treated as subject to section 4943(c)(4) with a first phase ending on May 25, 1984. Under downward ratchet of paragraph (a)(5) of this section, the foundation voting and value levels and the substituted combined voting and value levels are reduced to 25%.

Example 2. (i) F, a private foundation, owns 100% of the one outstanding class of stock in X corporation and 30% of the one outstanding class of stock in Y corporation. F has held this stock continuously since 1960, and no disqualified person has even owned any stock in X or Y. Under section 4943(c)(4), F's holdings in X are treated as held by disqualified persons through the end of the first phase on May 25, 1989, and F's holdings in Y are permitted holdings during the second phase, which began on May 25, 1989, and F's holdings in Y are permitted holdings during the second phase, which began on May 26, 1979. On January 1, 1985, X and Y consolidate, forming a new corporation Z. In the consolidation, F acquires 50% of the one class of outstanding stock of Z, 40% in exchange for F's 100% interest in X and 10% in exchange for F's 30% interest in Y. Unrelated parties hold the remaining 50% of Z.

(ii) F's percentage of voting power and value in Z after the merger (50%) are less than F's percentages of voting power and value in X before the merger (100%). Thus, under paragraph (a)(1) of this section, the 50% interest in Z held by F is treated as the stock surrendered in the exchange for purposes of section 4943(c)(4). Under paragraph (b)(6) of this section, the 10% interest in Z received for the Y stock is subject to the same second phase period as the surrendered Y stock. The 40% interest first phase period as the surrendered X stock.

Example 3. (i) F, a private foundation, owns 50% of the one class of outstanding stock in X corporation which F has held continuously since 1935. No disqualified person with respect to F owns any stock in X. Neither F nor any disqualified person with respect to F owns any stock in Y corporation. On July 1, 1982, X and Y enter into an agreement to consolidate their businesses in a reorganization to which section 368(a)(1)(A) will apply. As a result of the contemplated consolidation, F will own 60% of the voting stock in Z, the resulting corporation. In addition, parties unrelated to F will own the remaining 40% of the Z voting stock and 100% of a new issue of nonvoting preferred stock in Z. Assume for purposes of this example, that the 60% of the voting stock to be held by F in Z will represent 50% of the fair market value of the outstanding Z stock.

(ii) Under the provisions of paragraph (b)(1) of this section, that portion of the Z stock held by F which represents a percentage of voting power equivalent to that held by F in X immediately prior to the consolidation (*i.e.*, 50%) will be treated as the X stock held by F on May 26, 1969, for purposes of section 4943(c)(4). Therefore, 50% of the Y stock will

be treated as subject to a second phase ending on May 25, 1994. The remaining portion of the Z voting stock held by F (10%) is subject to the provisions of § 53.4943–6(d)(1). F will have five years from the date of the merger in which to dispose of 10% of the Z stock without incurring the tax on excess business holdings.

Example 4. (i) F, a private foundation, owns 80% of the one class of outstanding stock in X corporation, an active business corporation. F has held this stock continuously since 1960 and no disqualified person with respect to F owns any stock in X. X has two operating divisions, one which manufacturers shoes and the other which manufactures refrigerators. On January 1, 1978, in a section 351(a) exchange, X transferred all of the assets of its shoe manufacturing division to Y, a corporation which X has formed for this purpose, and receives 100% of the stock of Y so that Y is a wholly-owned subsidiary of X. X then transfers all of the Y stock to F in exchange for all of F's holdings of X stock in a distribution to which section 355 applies.

(ii) Under paragraph (b)(1) of this section, 80% of the Y stock is treated as the X stock surrendered in the exchange for purposes of section 4943(c)(4). The 80% is treated under § 53.4943–4(c) as held by disqualified persons through May 25, 1984, which constitutes the 15-year first phase holding period applicable to the 80% holding in X. The 80% of the Y stock must be reduced to the permitted holdings allowed during the second and third phase as provided by section 4943(c)(4)(D) in the same manner as F's holdings of X stock would have had to have been reduced.

(iii) Under § 53.4943–6(d)(1), the remaining 20% of Y stock is treated as held by a disqualified person for five years from the date of the exchange. F will have five years from the date of the exchange in which to dispose of 20% of the Y stock without incurring the tax on excess business holdings.

Example 5. (i) X corporation, an active business corporation, has outstanding 1,000 shares of one class of stock, of which 600 shares have been held by F1, a private foundation; 100 shares have been held by F2, another private foundation; and 100 shares have been held by D, a disqualified person with respect to both F1 and F2. Unrelated parties hold the remaining 200 shares. F1 and F2 are disqualified persons with respect to each other under section 4946(a)(1)(H). Thus, F1 holds 60% of the X stock (600/1000); F2 and D each hold 10% (100/1000); and the foundation group (F1, F2 and D) holds 80% of X (800/1000). The holdings of F1 and F2 were acquired on January 1, 1980 pursuant to a pre-1969 will and are subject to section 4943(c)(5). There have been no changes in holdings since January 1, 1980.

(ii) On January 1, 1985, pursuant to a plan to dispose of excess business holdings approved by the Commissioner under paragraph (c) of this section, X redeems for cash the 600 shares held by F1. After the redemption, D and F2 each hold 25% of X (100/400). F1 no longer holds any X stocks. The foundation group's holdings (F1, F2 and D) have decreased from 80% to 50% while holdings of unrelated parties have increased from 20% to 50%. At the same time F2's and D's holdings each have increased from 10% to 25%.

(iii) Notwithstanding the increase in F2's and D's holdings, under paragraph (c) of this section, all of the X stock held by F2 will be treated as held by a disqualified person through the end of the first phase (December 31, 1994). However, the foundation voting and value levels do not increase. Therefore, after the end of the first phase, F2's holdings in X may not exceed 10 percent (if the combined holdings of F1, F2 and D exceed the permitted holdings under section 4943(c)(2)).

Example 6. (i) X corporation, an active business corporation, has outstanding 1,000 shares of its one class of stock. Since 1960, 100 shares (10%) have been held by F, a private foundation and 350 shares (35%) have been held by D, a disqualified person with respect to F. All of the stock held by F is permitted holdings under section 4943(c)(4) and the substituted combined voting and value levels are 45% (10% + 35%). Because of disagreements concerning management of X between D and A, an unrelated party who holds 300 shares (30%) of the X stock, X redeems all of A's shares on December 1, 1981.

(ii) After the redemption, F holds 14.3% (100/700) of the X stock and D holds 50% (350/700), for combined holdings of 64.3%. Because the combined holdings exceed the substituted combined voting level (45%) by more than F's entire holdings, all of the F stock is excess business holdings. However, all of F's stock will be treated as acquired other than by purchase under § 53.4943–6(d)(1) and therefore will be treated under section 4943(c)(6) and this section, as held by a disqualified person for five years from the date of the redemption (through November 30, 1986). If the combined holdings of F and its disqualified person are reduced to 45 percent by the end of the five year period, F may retain a portion of its holdings in X (limited to no more than the foundation voting and value level of 10 percent).

Example 7. Assume the same facts as in *Example (6)*, except that D loaned the money to X that was used to redeem A's shares. Under these facts, the increased holdings result from a prohibited transaction described in paragraph (d)(2) of this section. Therefore, all of F's stock will be treated as acquired by purchase by a disqualified person under § 53.4943–6(d)(2). F will have 90 days after the redemption in which to dispose of its holdings or to reduce its holdings and the combined holdings to the levels held prior to the redemption as discussed in *Example (6)*.

Example 8. (i) F, a private foundation, has held 100% of the outstanding stock of X corporation since 1960. F also holds 15% of the voting stock of Y corporation. Both X and Y are active business corporations. X has $1 million in net assets used in its trade or business and Y has $6.7 million used in its trade or business. On June 1, 1985, Y is merged into X. After the merger F holds 25% of the voting stock of X. No person other than F controls X after the merger.

(ii) Because more than 40% of Y was acquired and the net assets of X, the acquiring corporation, used in its trade or business prior to the merger represent less than 15% of the net assets of Y used in its trade or business, the merger is a prohibited transaction described in paragraph (d)(2)(iii). Therefore, only 15% of the stock X is treated, pursuant to paragraph (b), as the stock held by F prior to the redemption. F's holding of 5% (the excess of F's 25% holdings over the 20% permitted holdings in X (determined under section 4943(c)(2)) are treated as purchased by a disqualified person pursuant to § 53.4943–6(d)(2). F will have 90 days after June 1, 1985, in which to dispose of the 5% excess holdings.

[T.D. 7944, 49 FR 6480, Feb. 22, 1984]

§ 53.4943–8 Business holdings; constructive ownership.

(a) *Constructive ownership*—(1) *In general.* For purposes of section 4943, in computing the holdings in a business enterprise of a private foundation, or a disqualified person (as defined in section 4946), any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries except as otherwise provied paragraphs (b), (c) and (d) of this section. Any interest in a business enterprise actually or constructively owned by a shareholder of a corporation, a partner of a partnership, or beneficiary of an estate or trust shall not be considered as constructively held by the corporation, partnership, trust or estate. Further, if any corporation, partnership, estate or trust has a warrant or other option to acquire an interest in a business enterprise, such interest is not deemed to be constructively owned by such entity until the option is exercised. (See paragraph (b)(2) of § 53.4943–3 for rules that options are not stock for purposes of determining excess business holdings.)

(2) *Powers of appointment.* Any interest in business enterprise over which a foundation or a disqualified person has a power of appointment exercisable in favor of the foundation or a disqualified person shall be considered owned by the foundation or disqualified person holding such power of appointment.

(3) *Determination of extent of constructive ownership.* If an interest in a business enterprise owned by a corporation is constructively owned by a shareholder, each shareholder's proportion of ownership is generally computed on the basis of the voting stock each shareholder has in the corporation. In determining holdings permitted under section 4943(c) (4) and (5), each shareholder's proportion of ownership in the business enterprise shall also be computed on the basis of value, taking into account both voting and nonvoting stock held by the shareholder.

(4) *Nonvoting stock.* If a private foundation, its disqualified persons, or both, own (directly or constructively) nonvoting stock of a parent corporation, the holdings of which are treated as constructively owned by its shareholders by reason of section 4943(d)(1) and this section, such nonvoting stock shall be treated as nonvoting stock of any corporation in which the parent corporation holds an interest for purposes of the limitation on the holding of nonvoting stock under section 4943(c)(2)(A) and § 53.4943–3(b)(2).

(5) *Interests held by certain disqualified persons.* In the case of an entity that is a disqualified person (other than an entity described in section 4946(a)(1)(H)), the holdings of which are treated as constructively owned by its shareholders, partners, or beneficiaries, for purposes of determining the total holdings of disqualified persons the holdings of the entity shall be considered held by a disqualified person only to the extent such holdings are treated as constructively owned by disqualified persons who are shareholders, partners, or beneficiaries of the entity. In the case of an entity described in section 4946(a)(1)(H) or an entity, the holdings of which are not treated as constructively owned by its shareholders, partners, or beneficiaries, all holdings of such entity shall be treated as held by

a disqualified person if and only if the entity itself is a disqualified person.

(b) *Estates and trusts*—(1) *In general*. Any interest actually or constructively owned by an estate or trust is deemed constructively owned, in the case of an estate, by its beneficiaries or, in the case of a trust, by its remainder beneficiaries except as provided in paragraphs (b) (2), (3) and (4) of this section (relating to certain split-interest trusts described in section 4947(a)(2), to trusts of qualified pension, profit-sharing, and stock bonus plans described in section 401(a) and to revocable trusts). Thus, if a trust owns 100 percent of the stock of a corporation A, and if, on an actuarial basis, W's life interest in the trust is 15 percent, Y's life interest is 25 percent, and Z's remainder interest is 60 percent, under this paragraph (b), Z will be considered to be the owner of 100 percent of the stock of corporation A. See § 53.4943–4, § 53.4943–5 and § 53.4943–6 for rules relating to certain actual or constructive holdings of a foundation being treated as held by a disqualified person. For the treatment of certain property acquired by an estate or trust after May 26, 1969, see paragraph (a)(2) of § 53.4943–5.

(2) *Split-interest trusts*—(i) *Amounts transferred in trust after May 26, 1969*. In the case of an interest in a business enterprise which was transferred to a trust described in section 4947(a)(2) after May 26, 1969, for the benefit of a private foundation, no portion of such interest shall be considered as owned by the private foundation:

(A) If the foundation holds only an income interest in the trust, or

(B) If the foundation holds only a remainder interest in the trust (unless the foundation can exercise primary investment discretion with respect to such interest)

until such trust ceases to be so described. See section 4947(a)(2) and (b)(3) and the regulations thereunder for rules relating to such trusts. See also sections 4946(a)(1) (G) and (H) and the regulations thereunder for rules relating to when a trust described in this paragraph (b)(2) is itself a disqualified person.

(ii) *Amounts transferred in trust on or before May 26, 1969*. In the case of an interest in a business enterprise which was transferred to a trust described in section 4947(a)(2) (without regard to section 4947(a)(2)(C)) on or before May 26, 1969, for the benefit of a private foundation, no portion of such interest shall be considered as owned by the foundation until it is actually distributed to the foundation or until the trust ceases to be so described. See section 4943(c)(5) and § 53.4943–5 for rules relating to certain trusts which were irrevocable on May 26, 1969.

(3) *Employee benefit trusts*. An interest in a business enterprise owned by a trust described in section 401(a) (pension and profit-sharing plans) shall not be considered as owned by its beneficiaries, unless disqualified persons (within the meaning of section 4946) control the investment of the trust assets.

(4) *Revocable trusts*. An interest in a business enterprise owned by a revocable trust shall be treated as owned by the grantor of such trust.

(5) *Estates*. For purposes of applying section 4943(d)(1) to estates, the term ''beneficiary'' includes any person (including a private foundation) entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution. However, a person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When pursuant to the preceding sentence, a person (including a private foundation) ceases to be a beneficiary, stock or another interest in a business enterprise owned by the estate shall not thereafter be considered owned by such person. If any person is the constructive owner of an interest in a business enterprise actually held by an estate, the date of death of the testator or decedent intestate shall be the first day on which such person shall be considered a constructive owner of such interest. See § 53.4943–5 for rules relating to wills executed on or before May 26, 1969.

(c) *Corporation actively engaged in a trade or business*—(1) *In general*. Except as provided in paragraphs (c)(2) and (3) of this section, any interest (whether or not in a separate entity) owned by a corporation which is actively engaged in a trade or business shall not be deemed to be constructively owned by such corporation's shareholders.

(2) *Actively engaged in a trade or business*. For purposes of paragraph (c)(1) of this section:

(i) A corporation shall not be considerd to be actively engaged in a trade or business if the corporation is not a business enterprise by reason of section 4943(d)(3) (A) or (B) and § 53.4943–10 (b) or (c);

(ii) In the case of a corporation which owns passive holdings and is actively engaged in a trade or business, such corporation shall not be considered to be actively engaged in a trade or business if the net assets used in such trade or business are insubstantial when compared to passive holdings.

(3) *Exceptions*. If a corporation has been involved in a prohibited transaction, any interest in a business enterprise owned by such corporation shall be treated as constructively owned by its shareholders, whether or not such corporation is actively engaged in a trade or business. For a definition of prohibited transaction, see § 53.4943–7 (d)(2).

(4) *Affiliated group*. In applying this paragraph to the common parent in an affiliated group (as defined in § 53.4943–10 (c)(3)(ii)), the assets and activities of the affiliated group shall be treated as the assets and activities of the common parent.

(d) *Partnerships*. Any interest in a business enterprise which is owned by a partnership shall be deemed to be constructively owned by the partners in such partnerships.

(e) *Examples*. The provisions of this section are illustrated by the following examples.

Example 1. F, a private foundation, directly owns voting stock of X, a holding company described in section 4943(d)(3)(B). That stock represents 40% of the voting power in X and 20% of the value of all outstanding shares of all classes of stock in X. F also owns nonvoting stock in X that represents 10% of the value of all outstanding shares of all classes of stock in X. D, a disqualified person, owns voting stock of X that represents 40% of the voting power in X and 20% of the value. D does not own any nonvoting stock in X. X corporation's only holding is stock of Y corporation. The Y voting stock held by X represents 50% of the voting power in Y and 25% of the value of all outstanding shares of all classes of stock in Y. X also owns nonvoting stock in Y that represents 25% of the value of all outstanding shares of all classes of stock in Y. Under paragraph (a)(3) of this section, F and D each constructively owns 20% of the voting power in Y through their voting interest in X (40% of X's 50% of Y). F also constructively owns 15% of the value of all outstanding shares of all classes of stock in Y through F's interest in X (F's 30% of the value of X multiplied by X's 50% of the value of Y), while D constructively owns 10% of the value of Y (D's 20% of the value of X multiplied by X's 50% of the value of Y).

Example 2. (i) F, a private foundation, owns 50% of the one class of nonvoting stock of X corporation, a corporation described in section 4943(d)(3)(B) and paragraph (c)(2)(i) above. D, a disqualified person with respect to F as described in section 4946(a)(1)(A), owns 40% of the one class of voting stock of X. X corporation is a disqualified person with respect to F because D owns more than 35% of the voting of X. (See section 4946(a)(1)(E)). On January 1, 1980, X purchases for cash 40% of the only class of stock of Y corporation, a retail clothing store, from unrelated third parties.

(ii) Under paragraph (a)(4) of this section, F is treated as owning nonvoting stock of Y. Although X is a disqualified person, its holdings are not treated as held by disqualified persons except as constructive holdings. Therefore, the ''deemed'' nonvoting stock in Y is a permitted holding because D, a disqualified person with respect to F, constructively owns only 16% of the voting stock of Y (less than 20% permitted under section 4943(c)(2)).

Example 3. (i) The facts are the same as in *Example (2)*, except that X purchases 100% of this stock of Y corporation. Under paragraph (a)(4) of this section, F is treated as owning nonvoting stock of Y. The ''deemed'' nonvoting stock in Y is not a permitted holdings because D, a disqualified person with respect to F, constructively owns 40% of the voting stock of Y.

Example 4. (i) D, a disqualified person with respect to F, owns 40% of the one class of stock in X corporation, an active business. X is a disqualified person with respect to F. X acquires 40% of the voting stock in Y corporation. Under paragraph (a)(5) of this section, the holdings of X in Y are treated as

held by a disqualified person. F cannot hold any Y stock, voting or nonvoting.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6484, Feb. 22, 1984]

§ 53.4943–9 Business holdings; certain periods.

(a) *Taxable period*—(1) *In general*. For purposes of section 4943, the term ''taxable period'' means, with respect to any excess business holdings of a private foundation in a business enterprise, the period beginning with the first day on which there are such excess business holdings and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed on the holdings by the section 4943(a);

(ii) The date on which the excess is eliminated; or

(iii) The date on which the tax imposed by section 4943(a) is assessed.

For example, *M*, a private foundation, first has excess business holdings in *X*, a corporation, on February 5, 1972. A notice of deficiency is mailed under section 6212 to *M* on June 1, 1974. With respect to *M*'s excess business holdings in *X*, the taxable period begins on February 5, 1972, and ends on June 1, 1974.

(2) *Special rule*. Where a notice of deficiency referred to in subparagraph (1)(i) of this paragraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

(3) *Suspension of taxable period for 90 days*. In any case in which a private foundation has excess business holdings solely because of the acquisition of an interest in a business enterprise to which paragraph (a)(1) (ii) or (iii) of § 53.4943–2 applies, the taxable period described in paragraph (a) of this section shall be suspended for the 90-day period (as extended) starting with the date on which the foundation knows or has reason to know of the acquisition, provided that at the end of such period the foundation has disposed of such excess holdings.

(b) *Cross reference*. For rules relating to taxable events that are corrected within the correction period, defined in section 4863(e), see section 4861(a) and the regulations thereunder.

(c) *Correction*. For purposes of section 4943, correction shall be considered as made when no interest in the enterprise held by the foundation is classified as an excess business holdings under section 4943(c)(1). In any case where the private foundation has excess business holdings which are constructively held for it under section 4943(c)(1), correction shall be considered made when either a corporation, partnership, estate, or trust in which holdings in such enterprise are constructively held for the foundation or a disqualified person; the foundation itself; or a disqualified person disposes of a sufficient interest in the enterprise so that no interest in the enterprise held by the foundation is classified as excess business holdings under section 4943(c)(1).

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4943–10 Business enterprise; definition.

(a) *In general*. (1) Except as provided in paragraph (b) or (c) of this section under section 4943(d)(4) the term ''business enterprise'' includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513. For purposes of the preceding sentence, where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from the classification of a business enterprise merely because it does not result in a profit.

(2) Notwithstanding paragraph (a)(1) of this section, a bond or other evidence of indebtedness does not constitute a holding in a business enterprise unless such bond or evidence of indebtedness is otherwise determined to be an equitable interest in such enterprise. Similarly, a lease-hold interest in real property does not constitute

an interest in a business enterprise, even though rent payable under such lease is dependent, in whole or in part, upon the income or profits derived by another from such property, unless such leasehold interest constitutes an interest in the income or profits of an unrelated trade or business under section 513.

(b) *Certain program-related activities.* For purposes of section 4943(d)(4) the term ''business enterprise'' does not include a functionally related business as defined in section 4942(j)(5). See § 53.4942(a)–2(c)(3)(iii). In addition, business holdings do not include program-related investments (such as investments in small businesses in central cities or in corporations to assist in neighborhood renovation) as defined in section 4944(c) and the regulations thereunder.

(c) *Income derived from passive sources*—(1) *In general.* For purposes of section 4943(d)(4), the term ''business enterprise'' does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources; except that if in the taxable year in question less than 95 percent of the income of a trade or business is from passive sources, the foundation may, in applying this 95 percent test, substitute for the passive source gross income in such taxable year the average gross income from passive sources for the 10 taxable years immediately preceding the taxable year in question (or for such shorter period as the entity has been in existence). Thus, stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1).

(2) *Gross income from passive sources.* Gross income from passive sources, for purposes of this paragraph, includes the items excluded by section 512(b)(1) (relating to dividends, interest, and annuities), 512(b)(2) (relating to royalties), 512(b)(3) (relating to rent) and 512(b)(5) (relating to gains or losses from the disposition of certain property). Any income classified as passive under this paragraph does not lose its character merely because section 512(b)(4) or 514 (relating to unrelated debt-financed income) applies to such income. In addition, income from passive sources includes income from the sale of goods (including charges or costs passed on at cost to purchasers of such goods or income received in settlement of a dispute concerning or in lieu of the exercise of the right to sell such goods) if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods. Thus, for example, where a corporation purchases a product under a contract with the manufacturer, resells it under contract at a uniform markup in price, and does not physically handle the product, the income derived from that markup meets the definition of passive income for purposes of this paragraph. On the other hand, income from individually negotiated sales, such as those made by a broker, would not meet such definition even if the broker did not physically handle the goods.

(3) *Affiliated group.* (i) For a common parent corporation in an affiliated group, substitute ''consolidated gross income'' in subparagraph (1) of this paragraph.

(ii) For purposes of this section, the term *affiliated group* shall have the same meaning as in section 1504(a), without regard to section 1504 (b) through (e).

(iii) Section 53.4943–11(d) provides a transitional rule for certain parent corporations.

(d) *Application of section 4943(c)(6)*—(1) *Program related activities.* If a private foundation holds an interest which is not an interest in a business enterprise because of paragraph (b) of this section (relating to program related activities), and such interest later becomes an interest in a business enterprise solely by reason of failing to meet the requirements of such paragraph (b), such interest will then be subject to section (regardless of when it was originally acquired) and will be treated as having been acquired other than by purchase for purposes of section 4943(c)(6).

(2) *Passive holdings, etc.* (i) Except as provided in subdivision (ii), if a private

foundation holds an interest that is not an interest in a business enterprise, and the interest later becomes an interest in a business enterprise (other than by reason of a readjustment as defined in § 53.4943–7(d)(1)), the interest will be treated as having been acquired by purchase by a disqualified person at the time the interest becomes an interest in a business enterprise. The treatment of an interest that becomes an interest in a business enterprise by reason of a readjustment shall be determined under § 53.4943–6 and § 53.4943–7.

(ii) If a private foundation establishes that the events which caused an interest not originally a business enterprise to become a business enterprise were not effectively controlled by the private foundation, then such interest shall be treated as acquired other than by purchase from the time of the change for purposes of section 4943(c)(6).

(iii) See § 53.4943–3(b)(3)(ii) for the definition of effective control.

(e) *Sole proprietorship.* For purposes of section 4943 and the regulations thereunder, the term ''sole proprietorship'' means any business enterprise (as defined in paragraphs (a), (b), and (c) of this section:

(1) Which is actually and directly owned by a private foundation,

(2) In which the foundation has a 100 percent equity interest, and

(3) Which is not held by a corporation, trust, or other business entity for such foundation.

A foundation may be considered to own a sole proprietorship even though the foundation is itself a corporation or a trust. However, a sole proprietorship which is owned by a foundation shall cease to be treated as a sole proprietorship when the foundation no longer has a 100-percent interest in the equity of the business enterprise. Thus, if and when a foundation sells a 10-percent interest in a sole proprietorship, such business enterprise shall be treated as a partnership under section 4943 and the regulations thereunder.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6484, Feb. 22, 1984]

§ 53.4943–11 Effective date.

(a) *In general.* Section 4943 and §§ 53.4943–1 through 53.4943–11 shall take effect for taxable years beginning after December 31, 1969, except as otherwise provided by such sections.

(b) *Special transitional rule.* In the case of any acquisition of excess holdings prior to February 2, 1973, section 4943(a)(1) shall not apply if correction occurs (within the meaning of paragraph (c) of § 53.4943–9) within a period ending 90 days after July 5, 1977 extended (prior to the expiration of the original period) by any period which the Commissioner determines is reasonable and necessary (within the meaning of paragraph (b) of § 53.4943–9) to bring about such correction.

(c) *Special transitional rule for acquisition by will, etc.* (1) The rule in § 53.4943–6(b)(1) whereby holdings not held by a decedent are not treated as acquired under a will shall not apply to acquisitions of after-acquired property of a decedent's estate occurring on or before May 22, 1984.

(2) The rule in § 53.4943–6(b)(1) treating a purchase by an estate as a purchase by a disqualified person where the executor is a disqualified person shall not apply to purchases occurring on or before May 22, 1984.

(d) *Special transitional rule for affiliated groups.* If on or before May 22, 1984 a foundation holds an interest in a common parent corporation in an affiliated group, as defined in § 53.4943–10(c)(3)(ii), the foundation may elect to have both § 53.4943–8(c)(4) and § 53.4943–10(c)(3) not apply to such common parent corporation. No election may be made to have only one section not apply. Such election shall be made by the governing body of the private foundation at any time prior to February 22, 1985.

(e) *Special transitional rule for changes to a business enterprise.* Any interest that is not an interest in a business enterprise which becomes an interest in a business enterprise under § 53.4943–10(d)(2) prior to May 22, 1984 will be treated as having been acquired other than by purchase for purposes of section 4943(c)(6).

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6485, Feb. 22, 1984]

Subpart E—Taxes on Investments Which Jeopardize Charitable Purpose

SOURCE: T.D. 7240, 37 FR 28747, Dec. 27, 1972, unless otherwise noted.

§ 53.4944–1 Initial taxes.

(a) *On the private foundation*—(1) *In general*. If a private foundation (as defined in section 509) invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, section 4944(a) (1) of the Code imposes an excise tax on the making of such investment. This tax is to be paid by the private foundation and is at the rate of 5 percent of the amount so invested for each taxable year (or part thereof) in the taxable period (as defined in section 4944(e) (1)). The tax imposed by section 4944(a)(1) and this paragraph shall apply to investments of either income or principal.

(2) *Jeopardizing investments*. (i) Except as provided in section 4944(c), § 53.4944–3, § 53.4944–6(a), and subdivision (ii) of this subparagraph, an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of ''puts,'' ''calls,'' and ''straddles,'' the purchase of warrants, and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently realizes a loss. The provisions of section 4944 and the regulations thereunder shall not exempt or relieve any person from compliance with any Federal or State law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of an organization or trust to which section 4944 applies. Nor shall any State law exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in section 4944 and the regulations thereunder.

(ii)(*a*) Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1)) in the amount of such consideration.

(*b*) Section 4944 shall not apply to an investment which is acquired by a private foundation solely as a result of a corporate reorganization within the meaning of section 368(a).

(iii) For purposes of section 4944, a private foundation which, after December 31, 1969, changes the form or terms

of an investment (regardless of whether subdivision (ii) of this subparagraph applies to such investment), will be considered to have entered into a new investment on the date of such change, except as provided in subdivision (ii)(*b*) of this subparagraph. Accordingly, a determination, under subdivision (i) of this subparagraph, whether such change in the investment jeopardizes the carrying out of the foundation's exempt purposes shall be made at such time.

(iv) It is not intended that the taxes imposed under Chapter 42 be exclusive. For example, if a foundation purchases a sole proprietorship in a business enterprise within the meaning of section 4943(d)(4), in addition to tax under section 4943, the foundation may be liable for tax under section 4944 if the investment jeopardizes the carrying out of any of its exempt purposes.

(b) *On the management*—(1) *In general.* In any case in which a tax is imposed by section 4944(a)(1) and paragraph (a) of this section, section 4944 (a)(2) of the Code imposes on the participation of any foundation manager in the making of the investment, knowing that it is jeopardizing the carrying out of any of the foundation's exempt purposes, a tax equal to 5 percent of the amount so invested for each taxable year of the foundation (or part thereof) in the taxable period (as defined in section 4944(e)(1)), subject to the provisions of section 4944(d) and § 53.4944–4, unless such participation is not willful and is due to reasonable cause. The tax imposed under section 4944(a)(2) shall be paid by the foundation manager.

(2) *Definitions and special rules*—(i) *Knowing.* For purposes of section 4944, a foundation manager shall be considered to have participated in the making of an investment ''knowing'' that it is jeopardizing the carrying out of any of the foundation's exempt purposes only if:

(*a*) He has actual knowledge of sufficient facts so that, based solely upon such facts, such investment would be a jeopardizing investment under paragraph (a)(2) of this section,

(*b*) He is aware that such an investment under these circumstances may violate the provisions of federal tax law governing jeopardizing investments, and

(*c*) He negligently fails to make reasonable attempts to ascertain whether the investment is a jeopardizing investment, or he is in fact aware that it is such an investment.

For purposes of this part and Chapter 42, the term *knowing* does not mean ''having reason to know''. However, evidence tending to show that a foundation manager has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of such fact or rule. Thus, for example, evidence tending to show that a foundation manager has reason to know of sufficient facts so that, based solely upon such facts, an investment would be a jeopardizing investment is relevant in determining whether he has actual knowledge of such facts.

(ii) *Willful.* A foundation manager's participation in a jeopardizing investment is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make such participation willfull. However, a foundation manager's participation in a jeopardizing investment is not willful if he does not know that it is a jeopardizing investment under paragraph (a)(2) of this section.

(iii) *Due to reasonable cause.* A foundation manager's actions are due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

(iv) *Participation.* The participation of any foundation manager in the making of an investment shall consist of any manifestation of approval of the investment.

(v) *Advice of counsel.* If a foundation manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that a particular investment would not jeopardize the carrying out of any of the foundation's exempt purposes (because, as a matter of law, the investment is excepted from such classification, for

example, as a program-related investment under section 4944(c)), then although such investment is subsequently held to be a jeopardizing investment under paragraph (a)(2) of this section, the foundation manager's participation in such investment will ordinarily not be considered ''knowing'' or ''willfull'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4944(a)(2). In addition, if a foundation manager, after full disclosure of the factual situation to qualified investment counsel, relies on the advice of such counsel, such advice being derived in a manner consistent with generally accepted practices of persons who are such a qualified investment counsel and being expressed in writing that a particular investment will provide for the long and short term financial needs of the foundation under paragraph (a)(2) of this section, then although such investment is subsequently held not to provide for such long and short term financial needs, the foundation manager's participation in failing to provide for such long and short term financial needs will ordinarily not be considered ''knowing'' or ''willful'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4944(a)(2). For purposes of this subdivision, a written legal opinion will be considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of legal counsel or qualified investment counsel with respect to the investment shall not, by itself, give rise to any inference that a foundation manager participated in such investment knowingly, willfully, or without reasonable cause.

(vi) *Cross reference.* For provisions relating to the burden of proof in cases involving the issue whether a foundation manager has knowingly participated in the making of a jeopardizing investment, see section 7454(b).

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. A is a foundation manager of B, a private foundation with assets of $100,000. A approves the following three investments by B after taking into account with respect to each of them B's portfolio as a whole: (1) An investment of $5,000 in the common stock of corporation X; (2) an investment of $10,000 in the common stock of corporation Y; and (3) an investment of $8,000 in the common stock of corporation Z. Corporation X has been in business a considerable time, its record of earnings is good and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of substantial long-term appreciation but with little prospect of a current return. A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B. Under the standards of paragraph (a)(2)(i) of this section, the investment of $10,000 in the common stock of Y and the investment of $8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of $5,000 in the common stock of X will not be so classified. B would then be liable for an initial tax of $500 (*i.e.*, 5 percent of $10,000) for each year (or part thereof) in the taxable period for the investment in Y, and an initial tax of $400 (*i.e.*, 5 percent of $8,000) for each year (or part thereof) in the taxable period for the investment in Z. Further, since A had actual knowledge that the investments in the common stock of Y and Z were jeopardizing investments, A would then be liable for the same amount of initial taxes as B.

Example 2. Assume the facts as stated in Example (1), except that: (1) In the case of corporation Y, B's investment will be made for new stock to be issued by Y and there is reason to anticipate that B's investment, together with investments required by B to be made concurrently with its own, will satisfy the capital needs of corporation Y and will thereby overcome the difficulties that have resulted in Y's uneven earnings record; and (2) in the case of corporation Z, the management has a demonstrated capacity for getting new businesses started successfully and Z has received substantial orders for its new

product. Under the standards of paragraph (a) (2) (i) of this section, neither the investment in Y nor the investment in Z will be classified as a jeopardizing investment and neither A nor B will be liable for an initial tax on either of such investments.

Example 3. D is a foundation manager of E, a private foundation with assets of $200,000. D was hired by E to manage E's investments after a careful review of D's training, experience and record in the field of investment management and advice indicated to E that D was well qualified to provide professional investment advice in the management of E's investment assets. D, after careful research into how best to diversify E's investments, provide for E's long-term financial needs, and protect against the effects of long-term inflation, decides to allocate a portion of E's investment assets to unimproved real estate in selected areas of the country where population patterns and economic factors strongly indicate continuing growth at a rapid rate. D determines that the short-term financial needs of E can be met through E's other investments. Under the standards of paragraph (a)(2)(i) of this section, the investment of a portion of E's investment assets in unimproved real estate will not be classified as a jeopardizing investment and neither D nor E will be liable for an initial tax on such investment.

[T.D. 7240, 37 FR 28747, Dec. 29, 1972, as amended by T.D. 7299, 38 FR 35304, Dec. 27, 1973]

§ 53.4944–2 Additional taxes.

(a) *On the private foundation.* Section 4944(b)(1) of the Code imposes an excise tax in any case in which an initial tax is imposed by section 4944(a)(1) and § 53.4944–1(a) on the making of a jeopardizing investment by a private foundation and such investment is not removed from jeopardy within the taxable period (as defined in section 4944(e)(1)). The tax imposed under section 4944(b)(1) is to be paid by the private foundation and is at the rate of 25 percent of the amount of the investment. This tax shall be imposed upon the portion of the investment which has not been removed from jeopardy within the taxable period.

(b) *On the management.* Section 4944(b)(2) of the Code imposes an excise tax in any case in which an additional tax is imposed by section 4944 (b)(1) and paragraph (a) of this section and a foundation manager has refused to agree to part or all of the removal of the investment from jeopardy. The tax imposed under section 4944(b)(2) is at the rate of 5 percent of the amount of the investment, subject to the provisions of section 4944(d) and § 53.4944–4. This tax is to be paid by any foundation manager who has refused to agree to the removal of part or all of the investment from jeopardy, and shall be imposed upon the portion of the investment which has not been removed from jeopardy within the taxable period.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. X is a foundation manager of Y, a private foundation. On the advice of X, Y invests $5,000 in the common stock of corporation M. Assume that both X and Y are liable for the taxes imposed by section 4944(a) on the making of the investment. Assume further that no part of the investment is removed from jeopardy within the taxable period and that X refused to agree to such removal. Y will be liable for an additional tax of $1,250 (*i.e.*, $5,000×25%). X will be liable for an additional tax of $250 (*i.e.*, $5,000×5%).

Example 2. Assume the facts as stated in Example (1), except that X is not liable for the tax imposed by section 4944(a)(2) for his participation in the making of the investment, because such participation was not willful and was due to reasonable cause. X will nonetheless be liable for the tax of $250 imposed by section 4944(b)(2) since an additional tax has been imposed upon Y and since X refused to agree to the removal of the investment from jeopardy.

Example 3. Assume the facts as stated in Example (1), except that Y removes $2,000 of the investment from jeopardy within the taxable period, with X refusing to agree to the removal from jeopardy of the remaining $3,000 of such investment. Y will be liable for an additional tax of $750, imposed upon the portion of the investment which has not been removed from jeopardy within the taxable period (*i.e.*, $3,000×25%). Further X will be liable for an additional tax of $150, also imposed upon the same portion of the investment (*i.e.*, $3,000×5%).

[T.D. 7240, 37 FR 28747, Dec. 27, 1972, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4944–3 Exception for program-related investments.

(a) *In general.* (1) For purposes of section 4944 and §§ 53.4944–1 through 53.4944–6, a ''program-related investment'' shall not be classified as an investment which jeopardizes the carrying out of the exempt purposes of a private foundation. A *program-related*

investment is an investment which possesses the following characteristics:

(i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);

(ii) No significant purpose of the investment is the production of income or the appreciation of property; and

(iii) No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D).

(2)(i) An investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities. For purposes of section 4944 and §§ 53.4944–1 through 53.4944–6, the term *purposes described in section 170(c)(2)(B)* shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

(ii) An investment in an activity described in section 4942(j)(5)(B) and the regulations thereunder shall be considered, for purposes of this paragraph, as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B).

(iii) In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(iv) An investment shall not be considered as made to accomplish one or more of the purposes described in section 170(c)(2)(D) if the recipient of the investment appears before, or communicates to, any legislative body with respect to legislation or proposed legislation of direct interest to such recipient, provided that the expense of engaging in such activities would qualify as a deduction under section 162.

(3)(i) Once it has been determined that an investment is ''program-related'' it shall not cease to qualify as a ''program-related investment'' provided that changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. A change made in the form or terms of a program-related investment for the prudent protection of the foundation's investment shall not ordinarily cause the investment to cease to qualify as program-related. Under certain conditions, a program-related investment may cease to be program-related because of a critical change in circumstances, as, for example, where it is serving an illegal purpose or the private purpose of the foundation or its managers. For purposes of the preceding sentence, an investment which ceases to be program-related because of a critical change in circumstances shall in no event subject the foundation making the investment to the tax imposed by section 4944(a)(1) before the 30th day after the date on which such foundation (or any of its managers) has actual knowledge of such critical change in circumstances.

(ii) If a private foundation changes the form or terms of an investment, and if, as a result of the application of subdivision (i) of this subparagraph, such investment no longer qualifies as program-related, the determination whether the investment jeopardizes the carrying out of exempt purposes shall be made pursuant to the provisions of § 53.4944–1(a)(2).

(b) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making

the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Example 2. Assume the facts as stated in Example (1), except that after the date of execution of the loan Y extends the due date of the loan. The extension is granted in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change in the terms of the loan is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property, the loan shall continue to qualify as a program-related investment.

Example 3. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example 4. X is a business enterprise which is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic well-being of a deteriorated urban area because X employes a substantial number of low-income persons from such area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration. No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 5. X is a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example 6. X is a business enterprise which is owned by a nonprofit community development corporation. When fully operational, X will market agricultural products, thereby providing a marketing outlet for low-income farmers in a depressed rural area. Y, a private foundation, makes a loan to X bearing interest at a rate less than the rate charged by financial institutions which have agreed to lend funds to X if Y makes the loan. The loan is made pursuant to a program run by Y to encourage economic redevelopment of depressed areas, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 7. X, a private foundation, invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

Example 8. S, a private foundation, makes an investment in T, a business corporation, which qualifies as a program-related investment under section 4944(c) at the time that it is made. All of T's voting stock is owned

by S. T experiences financial and management problems which, in the judgment of the foundation, require changes in management, in financial structure or in the form of the investment. The following three methods of resolving the problems appear feasible to S, but each of the three methods would result in reduction of the exempt purposes for which the program-related investment was initially made:

(*a*) *Sale of stock or assets*. The foundation sells its stock to an unrelated person. Payment is made in part at the time of sale; the balance is payable over an extended term of years with interest on the amount outstanding. The foundation receives a purchase-money mortgage.

(*b*) *Lease*. The corporation leases its assets for a term of years to an unrelated person, with an option in the lessee to buy the assets. If the option is exercised, the terms of payment are to be similar to those described in (*a*) of this example.

(*c*) *Management contract*. The corporation enters into a management contract which gives broad operating authority to one or more unrelated persons for a term of years. The foundation and the unrelated persons are obligated to contribute toward working capital requirements. The unrelated persons will be compensated by a fixed fee or a share of profits, and they will receive an option to buy the stock held by S or the assets of the corporation. If the option is exercised, the terms of payment are to be similar to those described in (*a*) of this example.

Each of the three methods involves a change in the form or terms of a program-related investment for the prudent protection of the foundation's investment. Thus, under § 53.4944–3(a)(3)(i), none of the three transactions (nor any debt instruments or other obligations held by S as a result of engaging in one of these transactions) would cause the investment to cease to qualify as program-related.

Example 9. X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 10. Y, a private foundation, makes a high-risk investment in low-income housing, the indebtedness with respect to which is insured by the Federal Housing Administration. Y's primary purpose in making the investment is to finance the purchase, rehabilitation, and construction of housing for low-income persons. The investment has no significant purpose involving the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the investment is program-related.

§ 53.4944–4 Special rules.

(a) *Joint and several liability*. In any case where more than one foundation manager is liable for the tax imposed under section 4944 (a)(2) or (b)(2) with respect to any one jeopardizing investment, all such foundation managers shall be jointly and severally liable for the tax imposed under each such paragraph with respect to such investment.

(b) *Limits on liability for management*. With respect to anyone jeopardizing investment, the maximum aggregate amount of tax collectible under section 4944(a)(2) from all foundation managers shall not exceed $5,000, and the maximum aggregate amount of tax collectible under section 4944(b)(2) from all foundation managers shall not exceed $10,000.

(c) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. A, B, and C are foundation managers of X, a private foundation. Assume that A, B, and C are liable for both initial and additional taxes under sections 4944(a)(2) and 4944(b)(2), respectively, for the following investments by X: an investment of $5,000 in the common stock of corporation M, and an investment of $10,000 in the common stock of corporation N. A, B, and C will be jointly and severally liable for the following initial taxes under section 4944(a)(2): a tax of $250 (*i.e.*, 5 percent of $5,000) for each year (or part thereof) in the taxable period (as defined in section 4944(e)(1)) for the investment in M, and a tax of $500 (*i.e.*, 5 percent of $10,000) for each year (or part thereof) in the taxable period for the investment in N. Further, A, B, and C will be jointly and severally liable for the following additional taxes under section 4944(b)(2): a tax of $250 (*i.e.*, 5 percent of $5,000) for the investment in M, and a tax of $500 (*i.e.*, 5 percent of $10,000) for the investment in N.

Example 2. Assume the facts as stated in Example (1), except that X has invested $500,000 in the common stock of M, and $1 million in the common stock of N. A, B, and C will be jointly and severally liable for the following initial taxes under section 4944(a)(2): a tax of $5,000 for the investment in M, and a tax of $5,000 for the investment

in N. Further, A, B, and C will be jointly and severally liable for the following additional taxes under section 4944(b) (2): a tax of $10,000 for the investment in M, and a tax of $10,000 for the investment in N.

§ 53.4944–5 Definitions.

(a) *Taxable period*—(1) *In general*. For purposes of section 4944, the term ''taxable period'' means, with respect to any investment which jeopardizes the carrying out of a private foundation's exempt purposes, the period beginning with the date on which the amount is invested and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed on the making of the investment by section 4944(a)(1);

(ii) The date on which the amount invested is removed from jeopardy; or

(iii) The date on which the tax imposed by section 4944(a)(1) is assessed.

(2) *Special rule*. Where a notice of deficiency referred to in subparagraph (1)(i) of this paragraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

(b) *Removal from jeopardy*. An investment which jeopardizes the carrying out of a private foundation's exempt purposes shall be considered to be removed from jeopardy when:

(1) The foundation sells or otherwise disposes of the investment, and

(2) The proceeds of such sale or other disposition are not themselves investments which jeopardize the carrying out of such foundation's exempt purposes.

A change by a private foundation in the form or terms of a jeopardizing investment shall result in the removal of the investment from jeopardy if, after such change, the investment no longer jeopardizes the carrying out of such foundation's exempt purposes. For purposes of section 4944, the making by a private foundation of one jeopardizing investment and a subsequent exchange by the foundation of such investment for another jeopardizing investment will be treated as only one jeopardizing investment, except as provided in § 53.4944–6 (b) and (c). For the treatment of a jeopardizing investment which is removed from jeopardy or otherwise transferred by a private foundation by the making of a grant or by bargain-sale, see sections 4941 and 4945 and the regulations thereunder. A jeopardizing investment cannot be removed from jeopardy by a transfer from a private foundation to another private foundation which is related to the transferor foundation within the meaning of section 4946(a) (1)(H) (i) or (ii), unless the investment is a program-related investment in the hands of the transferee foundation.

(c) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. X, a private foundation on the calendar year basis, makes a $1,000 jeopardizing investment on January 1, 1970. X thereafter sells the investment for $1,000 on January 3, 1971. The taxable period is from January 1, 1970, to January 3, 1971. X will be liable for an initial tax of $100, that is, a tax of 5 percent of the amount of the investment for each year (or part thereof) in the taxable period.

Example 2. Assume that both C and D are investments which jeopardize exempt purposes. X, a private foundation, purchases C in 1971 and later exchanges C for D. Such exchange does not constitute a removal of C from jeopardy. In addition, no new taxable period will arise with respect to D, since, for purposes of section 4944, only one jeopardizing investment has been made.

Example 3. Assume the facts as stated in Example (2), except that X sells C for cash and later reinvests such cash in D. Two separate investments jeopardizing exempt purposes have resulted. Since the cash received in the interim is not of a jeopardizing nature, the amount invested in C has been removed from jeopardy and, thus, the taxable period with respect to C has been terminated. The subsequent reinvestment of such cash in D gives rise to a new taxable period with respect to D.

(d) *Cross reference*. For rules relating to taxable events that are corrected within the correction period, defined in section 4963(e), see section 4961(a) and the regulations thereunder.

[T.D. 7240, 37 FR 28747, Dec. 27, 1972, as amended by T.D. 8084, 51 FR 16303, May 2, 1986]

§ 53.4944–6 Special rules for investments made prior to January 1, 1970.

(a) Except as provided in paragraph (b) or (c) of this section, an investment made by a private foundation prior to January 1, 1970, shall not be subject to the provisions of section 4944.

(b) If the form or terms of an investment made by a private foundation prior to January 1, 1970, are changed (other than as described in paragraph (c) of this section) on or after such date, the provisions of § 53.4944–1(a)(2)(iii) shall apply with respect to such investment.

(c) In the case of an investment made by a private foundation prior to January 1, 1970, which is exchanged on or after such date for another investment, for purposes of section 4944 the foundation will be considered to have made a new investment on the date of such exchange, unless the post-1969 investment is described in § 53.4944–1(a)(2)(ii)(*b*). Accordingly, a determination, under § 53.4944–1(a) (2)(i), whether the investment jeopardizes the carrying out of the foundation's exempt purposes shall be made at such time.

Subpart F—Taxes on Taxable Expenditures

SOURCE: T.D. 7215, 37 FR 23161, Oct. 31, 1972, unless otherwise noted.

§ 53.4945–1 Taxes on taxable expenditures.

(a) *Imposition of initial taxes*—(1) *Tax on private foundation.* Section 4945(a)(1) of the Code imposes an excise tax on each taxable expenditure (as defined in section 4945(d)) of a private foundation. This tax is to be paid by the private foundation and is at the rate of 10 percent of the amount of each taxable expenditure.

(2) *Tax on foundation manager*—(i) *In general.* Section 4945(a)(2) of the Code imposes, under certain circumstances, an excise tax on the agreement of any foundation manager to the making of a taxable expenditure by a private foundation. This tax is imposed only in cases in which the following circumstances are present:

(*a*) A tax is imposed by section 4945(a)(1);

(*b*) Such foundation manager knows that the expenditure to which he agrees is a taxable expenditure, and

(*c*) Such agreement is willfull and is not due to reasonable cause.

However, the tax with respect to any particular expenditure applies only to the agreement of those foundation managers who are authorized to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the foundation and to those foundation managers who are members of a group (such as the foundation's board of directors or trustees) which is so authorized. For the definition of the term *foundation manager*, see section 4946(b) and the regulations thereunder.

(ii) *Agreement.* The agreement of any foundation manager to the making of a taxable expenditure shall consist of any manifestation of approval of the expenditure which is sufficient to constitute an exercise of the foundation manager's authority to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the foundation, whether or not such manifestation of approval is the final or decisive approval on behalf of the foundation.

(iii) *Knowing.* For purposes of section 4945, a foundation mangager shall be considered to have agreed to an expenditure ''knowing'' that it is a taxable expenditure only if:

(*a*) He has actual knowledge of sufficient facts so that, based solely upon such facts, such expenditure would be a taxable expenditure,

(*b*) He is aware that such an expenditure under these circumstances may violate the provisions of federal tax law governing taxable expenditures, and

(*c*) He negligently fails to make reasonable attempts to ascertain whether the expenditure is a taxable expenditure, or he is in fact aware that it is such an expenditure.

For purposes of this part and Chapter 42, the term *knowing* does not mean ''having reason to know''. However, evidence tending to show that a foundation manager has reason to know of a particular fact or particular rule is relevant in determining whether he

had actual knowledge of such fact or rule. Thus, for example, evidence tending to show that a foundation manager has reason to know of sufficient facts so that, based solely upon such facts, an expenditure would be a taxable expenditure is relevant in determining whether he has actual knowledge of such facts.

(iv) *Willful*. A foundation manager's agreement to a taxable expenditure is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an agreement willful. However, a foundation manager's agreement to a taxable expenditure is not willful if he does not know that it is a taxable expenditure.

(v) *Due to reasonable cause*. A foundation manager's actions are due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

(vi) *Advice of counsel*. If a foundation manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that an expenditure is not a taxable expenditure under section 4945 (or that expenditures conforming to certain guidelines are not taxable expenditures), although such expenditure is subsequently held to be a taxable expenditure (or that certain proposed reporting procedures with respect to an expenditure will satisfy the tests of section 4945(h), although such procedures are subsequently held not to satisfy such section), the foundation manager's agreement to such expenditure (or to grants made with provision for such reporting procedures which are taxable solely because of such inadequate reporting procedures) will ordinarily not be considered ''knowing'' or ''willful'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4945(a)(2). For purposes of the subdivision, a written legal opinion will be considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an expenditure shall not, by itself, give rise to any inference that a foundation manager agreed to the making of the expenditure knowingly, willfully, or without reasonable cause.

(vii) *Rate and incidence of tax*. The tax imposed under section 4945(a)(2) is at the rate of 2½ percent of the amount of each taxable expenditure to which the foundation manager has agreed. This tax shall be paid by the foundation manager.

(viii) *Cross reference*. For provisions relating to the burden of proof in cases involving the issue whether a foundation manager has knowingly agreed to the making of a taxable expenditure, see section 7454(b).

(b) *Imposition of additional taxes*—(1) *Tax on private foundation*. Section 4945(b)(1) of the Code imposes an excise tax in any case in which an initial tax is imposed under section 4945(a)(1) on a taxable expenditure of a private foundation and the expenditure is not corrected within the taxable period (as defined in section 4945(i)(2)). The tax imposed under section 4945(b)(1) is to be paid by the private foundation and is at the rate of 100 percent of the amount of each taxable expenditure.

(2) *Tax on foundation manager*. Section 4945(b)(2) of the Code imposes an excise tax in any case in which a tax is imposed under section 4945(b)(1) and a foundation manager has refused to agree to part or all of the correction of the taxable expenditure. The tax imposed under section 4945(b)(2) is at the rate of 50 percent of the amount of the taxable expenditure. This tax is to be paid by any foundation manager who has refused to agree to part or all of the correction of the taxable expenditure.

(c) *Special rules*—(1) *Joint and several liability*. In any case where more than one foundation manager is liable for tax imposed under section 4945 (a) (2) or (b)(2) with respect to the making of a taxable expenditure, all such foundation managers shall be jointly and severally liable for the tax imposed under such paragraph with respect to such taxable expenditure.

(2) *Limits on liability for management.* The maximum aggregate amount of tax collectible under section 4945(a)(2) from all foundation managers with respect to any one taxable expenditure shall be $5,000, and the maximum aggregate amount of tax collectible under section 4945(b) (2) from all foundation managers with respect to any one taxable expenditure shall be $10,000.

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

Example 1. A, B, and C comprise the board of directors of Foundation M. They vote unanimously in favor of a grant of $100,000 to D, a business associate of each of the directors. The grant is to be used by D for travel and educational purposes and is not made in accordance with the requirements of section 4945(g). Each director knows that D was selected as the recipient of the grant solely because of his friendship with the directors and is aware that some grants made for travel, study, or other similar purposes may be taxable expenditures. Also, none of the directors makes any attempt to consult counsel, or to otherwise determine, whether this grant is a taxable expenditure. Initial taxes are imposed under paragraphs (1) and (2) of section 4945(a). The tax to be paid by the foundation is $10,000 (10 percent of $100,000). The tax to be paid by the board of directors is $2,500 (2½ percent of $100,000). A, B, and C are jointly and severally liable for this $2,500 and this sum may be collected by the Service from any one of them.

Example 2. Assume the same facts as in example (1). Further assume that within the taxable period A makes a motion to correct the taxable expenditure at a meeting of the board of directors. The motion is defeated by a two-to-one vote, A voting for the motion and B and C voting against it. In these circumstances an additional tax is imposed on the private foundation in the amount of $100,000 (100 percent of $100,000). The additional tax imposed on B and C is $10,000 (50 percent of $100,000 subject to a maximum of $10,000). B and C are jointly and severally liable for the $10,000, and this sum may be collected by the Service from either of them.

(d) *Correction*—(1) *In general.* Except as provided in paragraph (d) (2) or (3) of this paragraph, correction of a taxable expenditure shall be accomplished by recovering part or all of the expenditure to the extent recovery is possible, and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe. Such additional corrective action is to be determined by the circumstances of each particular case and may include the following:

(i) Requiring that any unpaid funds due the grantee be withheld;

(ii) Requiring that no further grants be made to the particular grantee;

(iii) In addition to other reports that are required, requiring periodic (e.g., quarterly) reports from the foundation with respect to all expenditures of the foundation (such reports shall be equivalent in detail to the reports required by section 4945(h)(3) and § 53.4945–5(d));

(iv) Requiring improved methods of exercising expenditure responsibility;

(v) Requiring improved methods of selecting recipients of individual grants; and

(vi) Requiring such other measures as the Commissioner may prescribe in a particular case.

The foundation making the expenditure shall not be under any obligation to attempt to recover the expenditure by legal action if such action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Correction for inadequate reporting.* If the expenditure is taxable only because of a failure to obtain a full and complete report as required by section 4945(h)(2) or because of a failure to make a full and detailed report as required by section 4945(h)(3), correction may be accomplished by obtaining or making the report in question. In addition, if the expenditure is taxable only because of a failure to obtain a full and complete report as required by section 4945(h)(2) and an investigation indicates that no grant funds have been diverted to any use not in furtherance of a purpose specified in the grant, correction may be accomplished by exerting all reasonable efforts to obtain the report in question and reporting the failure to the Internal Revenue Service, even though the report is not finally obtained.

(3) *Correction for failure to obtain advance approval.* Where an expenditure is taxable under section 4945(d)(3) only because of a failure to obtain advance approval of procedures with respect to grants as required by section 4945(g), correction may be accomplished by obtaining approval of the grant making procedures and establishing to the satisfaction of the Commissioner that:

(i) No grant funds have been diverted to any use not in furtherance of a purpose specified in the grant;

(ii) The grant making procedures instituted would have been approved if advance approval of such procedures had been properly requested; and

(iii) Where advance approval of grant making procedures is subsequently required, such approval will be properly requested.

(e) *Certain periods*—(1) *Taxable period*. For purposes of section 4945, the term ''taxable period'' means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed on taxable expenditures by section 4945(a)(1); or

(ii) The date on which the tax imposed by section 4945(a)(1) is assessed.

(2) *Cross reference*. For rules relating to taxable events that are corrected within the correction period, defined in section 4963(e), see section 4961(a) and the regulations thereunder.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972, as amended by T.D. 7299, 38 FR 35305, Dec. 27, 1973; T.D. 7527, 42 FR 64625, Dec. 27, 1977; T.D. 8084, 51 FR 16303, May 2, 1986]

§ 53.4945–2 Propaganda influencing legislation.

(a) *Propaganda influencing legislation, etc.*—(1) *In general*. Under section 4945(d)(1) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation. An expenditure is an attempt to influence legislation if it is for a direct or grass roots lobbying communication, as defined in § 56.4911–2 (without reference to §§ 56.4911–2(b)(3) and 56.4911–2(c)) and § 56.4911–3. See, however, paragraph (d) of this section for exceptions to the general rule of this paragraph (a)(1).

(2) *Expenditures for membership communications*. Section 56.4911–5, which provides special rules for electing public charities' communications with their members, does not apply to private foundations. Thus, whether a private foundation's communications with its members (assuming it has any) are lobbying communications is determined solely under § 56.4911–2 and without reference to § 56.4911–5. However, where a private foundation makes a grant to an electing public charity, § 56.4911–5 applies to the electing public charity's communications with its own members. Therefore, in the limited context of determining whether a private foundation's grant to an electing public charity is a taxable expenditure under section 4945, the § 56.4911–5 membership rules apply. For example, if the grant is specifically earmarked for a communication from the electing public charity to its members and the communication is, because of § 56.4911–5, a nonlobbying communication, the grant is not a taxable expenditure under section 4945.

(3) *Jointly funded projects*. A private foundation will not be treated as having paid or incurred any amount to attempt to influence legislation merely because it makes a grant to another organization upon the condition that the recipient obtain a matching support appropriation from a governmental body. In addition, a private foundation will not be treated as having made taxable expenditures of amounts paid or incurred in carrying on discussions with officials of governmental bodies provided that:

(i) The subject of such discussions is a program which is jointly funded by the foundation and the Government or is a new program which may be jointly funded by the foundation and the Government,

(ii) The discussions are undertaken for the purpose of exchanging data and information on the subject matter of the programs, and

(iii) Such discussions are not undertaken by foundation managers in order to make any direct attempt to persuade governmental officials or employees to take particular positions on specific legislative issues other than such program.

(4) *Certain expenditures by recipients of program-related investments*. Any amount paid or incurred by a recipient of a program-related investment (as defined in § 53.4944–3) in connection with

an appearance before, or communication with, any legislative body with respect to legislation or proposed legislation of direct interest to such recipient shall not be attributed to the investing foundation, if:

(i) The foundation does not earmark its funds to be used for any activities described in section 4945(d) (1) and

(ii) A deduction under section 162 is allowable to the recipient for such amount.

(5) *Grants to public organizations*—(i) *In general*. A grant by a private foundation to an organization described in section 509(a) (1), (2) or (3) does not constitute a taxable expenditure by the foundation under section 4945(d), other than under section 4945(d)(1), if the grant by the private foundation is not earmarked to be used for any activity described in section 4945(d) (2) or (5), is not earmarked to be used in a manner which would violate section 4945(d) (3) or (4), and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the grantee to engage in any such prohibited activity or to select the recipient to which the grant is to be devoted. For purposes of this paragraph (a)(5)(i), a grant by a private foundation is earmarked if the grant is given pursuant to an agreement, oral or written, that the grant will be used for specific purposes. For the expenditure responsibility requirements with respect to organizations other than those described in section 509(a) (1), (2), or (3), see § 53.4945–5. For rules for determining whether grants to public charities are taxable expenditures under section 4945(d)(1), see paragraphs (a)(2), (a)(6) and (a)(7) of this section.

(ii) *Certain ''public'' organizations*. For purposes of this section, an organization shall be considered a section 509(a)(1) organization if it is treated as such under subparagraph (4) of § 53.4945–5(a).

(6) *Grants to public organizations that attempt to influence legislation*—(i) *General support grant*. A general support grant by a private foundation to the organization described in section 509(a) (1), (2), or (3) (a ''public charity'' for purposes of paragraphs (a) (6) and (7) of this section) does not constitute a taxable expenditure under section 4945(d)(1) to the extent that the grant is not earmarked, within the meaning of § 53.4945–2(a)(5)(i), to be used in an attempt to influence legislation. The preceding sentence applies without regard to whether the public charity has made the election under section 501(h).

(ii) *Specific project grant*. A grant, by a private foundation to fund a specific project of a public charity is not a taxable expenditure by the foundation under section 4945(d)(1) to the extent that—

(A) The grant is not earmarked, within the meaning of § 53.4945–2(a)(5)(i), to be used in an attempt to influence legislation, and

(B) The amount of the grant, together with other grants by the same private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation. If the grant is for more than one year, the preceding sentence applies to each year of the grant with the amount of the grant measured by the amount actually disbursed by the private foundation in each year or divided equally between years, at the option of the private foundation. The same method of measuring the annual amount must be used in all years of a grant. This paragraph (a)(6)(ii) applies without regard to whether the public charity has made the election under section 501(h).

(iii) *Reliance upon grantee's budget*. For purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation under paragraph (a)(6)(ii) of this section, a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

(7) *Grants to organizations that cease to be described in 501(c)(3)*—(i) *Not taxable expenditure; conditions*. A grant to a

public charity (as defined in paragraph (a)(6)(i) of this section) that thereafter ceases to be an organization described in section 501(c)(3) by reason of its attempts to influence legislation is not a taxable expenditure if—

(A) The grant meets the requirements of paragraph (a)(6) of this section,

(B) The recipient organization had received a ruling or determination letter, or an advance ruling or determination letter, that it is described in sections 501(c)(3) and 509(a),

(C) Notice of a change in the recipient organization's status has not been made to the public (such as by publication in the Internal Revenue Bulletin), and the private foundation has not acquired knowledge that the Internal Revenue Service has given notice to the recipient organization that it will be deleted from such status; and

(D) The recipient organization is not controlled directly or indirectly by the private foundation. A recipient organization is controlled by a private foundation for this purpose if the private foundation and disqualified persons (defined in section 4946(a)(1) (A) through (H) with reference to the private foundation, by aggregating their votes or positions of authority, can cause or prevent action on legislative issues by the recipient.

(ii) *Examples*. The provisions of paragraphs (a)(6) and (a)(7) of this section are illustrated by the following examples:

Example 1. W, a private foundation, makes a general support grant to Z, a public charity described in section 509(a)(1). Z informs W that, as an insubstantial portion of its activities, Z attempts to influence the State legislature with regard to changes in the mental health laws. The use of the grant is not earmarked by W to be used in a manner that would violate section 4945(d)(1). Even if the grant is subsequently devoted by Z to its legislative activities, the grant by W is not a taxable expenditure under section 4945(d).

Example 2. X, a private foundation, makes a specific project grant to Y University for the purpose of conducting research on the potential environmental effects of certain pesticides. X does not earmark the grant for any purpose that would violate section 4945(d)(1) and there is no oral or written agreement or understanding whereby X may cause Y to engage in any activity described in section 4945(d) (1), (2), or (5), or to select any recipient to which the grant may be devoted. Further, X determines, based on budget information supplied by Y, that Y's budget for the project does not contain any amount for attempts to influence legislation. X has no reason to doubt the accuracy or reliability of the budget information. Y uses most of the funds for the research project; however, Y expends a portion of the grant funds to send a representative to testify at Congressional hearings on a specific bill proposing certain pesticide control measures. The portion of the grant funds expended with respect to the Congressional hearings is not treated as a taxable expenditure by X under section 4945(d)(1).

Example 3. M, a private foundation, makes a specific project grant of $150,000 to P, a public charity described in section 509(a)(1). In requesting the grant from M, P stated that the total budgeted cost of the project is $200,000, and that of this amount $20,000 is allocated to attempts to influence legislation related to the project. M relies on the budget figures provided by P in determining the amount P will spend on influencing legislation and M has no reason to doubt the accuracy or reliability of P's budget figures. In making the grant, M did not earmark any of the funds from the grant to be used for attempts to influence legislation. M's grant of $150,000 to P will not constitute a taxable expenditure under section 4945(d)(1) because M did not earmark any of the funds for attempts to influence legislation and because the amount of its grant ($150,000) does not exceed the amount allocated to specific project activities that are not attempts to influence legislation ($200,000 − $20,000=$180,000).

Example 4. Assume the same facts as in example (3), except that M's grant letter to P provides that M has the right to renegotiate the terms of the grant if there is a substantial deviation from those terms. This additional fact does not make M's grant a taxable expenditure under section 4945(d)(1).

Example 5. Assume the same facts as in example (3), except that M made a specific project grant of $200,000 to P. Part of M's grant of $200,000 will constitute a taxable expenditure under section 4945(d)(1). The amount of the grant ($200,000) exceeds by $20,000 the amount P allocated to specific project activities that are not attempts to influence legislation ($180,000). M has made a taxable expenditure of $20,000.

Example 6. Assume the same facts as example (3), except that M made a specific project grant of $180,000, and received from P an enforceable commitment that grant funds would not be used in connection with attempts to influence legislation. M's grant is not a taxable expenditure under section 4945(d)(1).

Example 7. Assume the same facts as in example (3) except that M directed P to hire A, an individual, to expend $20,000 from the

grant to engage in direct lobbying (within the meaning of § 56.4911–2(b)) and grass roots lobbying (within the meaning of § 56.4911–2(c)). P does not expend any other grant funds for lobbying activities. The $20,000 that is earmarked for direct lobbying and grass roots lobbying is a taxable expenditure under section 4945(d)(1).

Example 8. R, a public charity described in section 509(a)(1), requested N, a private foundation, to make a general purpose grant to it to aid R in carrying out its exempt purpose. In making this request, R notified N that it had elected the expenditure test under section 501(h) and that it expected to attempt to influence legislation in areas related to its exempt purpose. Since its formation, R generally has had exempt purpose expenditures (as defined in § 56.4911–4) in excess of $7,000,000 in each of its taxable years, and has budgeted in excess of $7,000,000 of exempt purpose expenditures for the year of the grant. N made a grant of $200,000 to R. N did not earmark the funds for R's attempt to influence legislation. The general purpose grant by N does not constitute a taxable expenditure under section 4945(d)(1).

Example 9. Assume the same facts as in example (8), except that N learns that R has had excess lobbying expenditures (within the meaning of § 56.4911–1(b)) in some prior years. N also learns that in no year has R's lobbying or grass roots expenditures (within the meaning of § 56.4911–2 (a) and (c)) exceeded the corresponding ceiling amount (within the meaning of § 1.501(h)–3(c) (3) and (6)). N then makes the grant to R. After receiving the grant, R spends a large portion of its funds on influencing legislation and, as a consequence, is denied exemption from tax, as an organization described in section 501(c)(3), under section 501(h) and § 1.501(h)–3. No disqualified person with respect to N controlled, in whole or in part, R's attempts to influence legislation. The general purpose grant will not constitute a taxable expenditure under section 4945(d)(1).

Example 10. X, a private foundation, makes a specific project grant to Y, a public charity described in section 509(a). In requesting the grant, Y stated that it planned to use the funds to purchase a computer for purpose of computerizing its research files and that the grant will not be used to influence legislation. Two years after X makes the grant, X discovers that Y has also used the computer for purposes of maintaining and updating the mailing list for Y's lobbying newsletter. Because X did not earmark any of the grant funds to be used for attempts to influence legislation and because X had no reason to doubt the accuracy or reliability of Y's documents representing that the grant would not be used to influence legislation, X's grant is not treated as a taxable expenditure.

Example 11. G, a private foundation, makes a specific project grant of $300,000 to L, a public charity described in section 509(a)(1) for a three-year specific project studying child care problems. L provides budget material indicating that the specific project will expend $200,000 in each of three years. L's budget materials indicate that attempts to influence legislation will amount to $10,000 in the first year, $20,000 in the second year and $100,000 in the third year. G intends to pay its $300,000 grant over three years as follows: $200,000 in the first year, $50,000 in the second year and $50,000 in the third year. The amount of the grant actually disbursed by G in the first year of the grant exceeds the nonlobbying expenditures of L in that year. However, because the amount of the grant in each of the three years, when divided equally among the three years ($100,000 for each year), is not more than the nonlobbying expenditures of L on the specific project for any of the three years, none of the grant is treated as a taxable expenditure under section 4945(d)(1).

Example 12. P, a private foundation, makes a $120,000 specific project grant to C, a public charity described in section 509(a) for a three-year project. P intends to pay its grant to C in three equal annual installments of $40,000. C provides budget material indicating that the specific project will expend $100,000 in each of three years. C's budget materials, which P reasonably does not doubt, indicate that the project's attempts to influence legislation will amount to $50,000 in each of the three years. After P pays the first annual installment to C, but before P pays the second installment to C, reliable information comes to P's attention that C has spent $90,000 of the project's $100,000 first-year budget on attempts to influence legislation. This information causes P to doubt the accuracy and reliability of C's budget materials. Because of the information, P does not pay the second-year installment to C. P's payment of the first installment of $40,000 is not a taxable expenditure under section 4945(d)(1) because the grant in the first year is not more than the nonlobbying expenditures C projected in its budget materials that P reasonably did not doubt.

Example 13. Assume the same facts as in Example (12), except that P pays the second-year installment of $40,000 to C. In the project's second year, C once again spends $90,000 of the project's $100,000 annual budget in attempts to influence legislation. Because P doubts or reasonably should doubt the accuracy or reliability of C's budget materials when P makes the second-year grant payment, P may not rely upon C's budget documents at that time. Accordingly, although none of the $40,000 paid in the first installment is a taxable expenditure, only $10,000 ($100,000 minus $90,000) of the second-year grant payment is not a taxable expenditure.

The remaining $30,000 of the second installment is a taxable expenditure within the meaning of section 4945(d)(1).

Example 14. B, a private foundation, makes a specific project grant to C, a public charity described in section 509(a), of $40,000 for the purpose of conducting a study on the effectiveness of seat belts in preventing traffic deaths. B did not earmark any of the grant for attempts to influence legislation. In requesting the grant from B, C submitted a budget of $100,000 for the project. The budget contained expenses for postage and mailing, computer time, advertising, consulting services, salaries, printing, advertising, and similar categories of expenses. C also submitted to B a statement, signed by an officer of C, that 30% of the budgeted funds would be devoted to attempts to influence legislation within the meaning of section 4945. B has no reason to doubt the accuracy of the budget figures or the statement. B may rely on the budget figures and signed statement provided by C in determining the amount C will spend on influencing legislation. B's grant to C will not constitute a taxable expenditure under section 4945(d)(1), because the amount of the grant does not exceed the amount allocated to specific project activities that are not attempts to influence legislation.

(b)–(c) [Reserved]

(d) *Exceptions*—(1) *Nonpartisan analysis, study, or research*—(i) *In general.* A communication is not a lobbying communication, for purposes of § 53.4945–2(a)(1), if the communication constitutes engaging in nonpartisan analysis, study or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work. Accordingly, an expenditure for such a communication does not constitute a taxable expenditure under section 4945(d)(1) and § 53.4945–2(a)(1).

(ii) *Nonpartisan analysis, study, or research.* For purposes of section 4945(e), ''nonpartisan analysis, study, or research'' means an independent and objective exposition of a particular subject matter, including any activity that is ''educational'' within the meaning of § 1.501(c)(3)–1(d)(3). Thus, ''nonpartisan analysis, study, or research'' may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. On the other hand, the mere presentation of unsupported opinion does not qualify as ''nonpartisan analysis, study, or research''.

(iii) *Presentation as part of a series.* Normally, whether a publication or broadcast qualifies as ''nonpartisan analysis, study, or research'' will be determined on a presentation-by-presentation basis. However, if a publication or broadcast is one of a series prepared or supported by a private foundation and the series as a whole meets the standards of subdivision (ii) of this subparagraph, then any individual publication or broadcast within the series will not result in a taxable expenditure even though such individual broadcast or publication does not, by itself, meet the standards of subdivision (ii) of this subparagraph. Whether a broadcast or publication is considered part of a series will ordinarily depend on all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of 6 consecutive months will ordinarily be eligible to be considered as part of a series. If a private foundation times or channels a part of a series which is described in this subdivision in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal in violation of section 4945(d)(1), the expenses of preparing and distributing such part of the analysis, study, or research will be a taxable expenditure under this section.

(iv) *Making available results of analysis, study, or research.* A private foundation may choose any suitable means, including oral or written presentations, to distribute the results of its nonpartisan analysis, study, or research, with or without charge. Such means include distribution of reprints of speeches, articles, and reports (including the report required under section 6056); presentation of information through conferences, meetings, and discussions; and dissemination to the news media, including radio, television, and newspapers, and to other public forums. For purposes of this

paragraph (d)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of certain analysis, study, or research*—(A) *In general.* Even though certain analysis, study or research is initially within the exception for nonpartisan analysis, study, or research, subsequent use of that analysis, study or research for grass roots lobbying may cause that analysis, study or research to be treated as a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study, or research. This paragraph (d)(1)(v) of this section does not cause any analysis, study, or research to be considered a direct lobbying communication. For rules regarding when analysis, study, or research is treated as a grass roots lobbying communication that is not within the scope of the exception for nonpartisan analysis, study, or research, see § 56.4911–2(b)(2)(v).

(B) *Special rule for grants to public charities.* This paragraph (d)(1)(v)(B) of this section applies where a public charity uses a private foundation grant to finance, in whole or in part, a nonlobbying communication that is subsequently used in lobbying, causing the public charity's expenditures for the communication to be treated as lobbying expenditures under the subsequent use. In such a case, the private foundation's grant will ordinarily not be characterized as a lobbying expenditure by virtue of the subsequent use rule. The only situations where the private foundation's grant will be treated as a lobbying expenditure under the subsequent use rule are where the private foundation's primary purpose in making the grant to the public charity was for lobbying or where, at the time of making the grant, the private foundation knows (or in light of all the facts and circumstances reasonably should know) that the public charity's primary purpose in preparing the communication to be funded by the grant is for use in lobbying.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception of this § 53.4945–2(d)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in one or more of § 56.4911–2(b)(2)(iii)(A) through (C). As described in § 56.4911–2(b)(2)(iv), a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation.

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

Example 1. M, a private foundation, establishes a research project to collect information for the purpose of showing the dangers of the use of pesticides in raising crops. The information collected includes data with respect to proposed legislation, pending before several State legislatures, which would ban the use of pesticides. The project takes favorable positions on such legislation without producing a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion on the pros and cons of the use of pesticides. This project is not within the exception for nonpartisan analysis, study, or research because it is designed to present information merely on one side of the legislative controversy.

Example 2. N, a private foundation, establishes a research project to collect information concerning the dangers of the use of pesticides in raising crops for the ostensible purpose of examining and reporting information as to the pros and cons of the use of pesticides in raising crops. The information is collected and distributed in the form of a published report which analyzes the effects and costs of the use and nonuse of various pesticides under various conditions on humans, animals, and crops. The report also presents the advantages, disadvantages, and economic cost of allowing the continued use of pesticides unabated, of controlling the use of pesticides, and of developing alternatives to pesticides. Even if the report sets forth

conclusions that the disadvantages as a result of using pesticides are greater than the advantages of using pesticides and that prompt legislative regulation of the use of pesticides is needed, the project is within the exception for nonpartisan analysis, study or research since it is designed to present information on both sides of the legislative controversy and presents a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion.

Example 3. O, a private foundation, establishes a research project to collect information on the presence or absence of disease in humans from eating food grown with pesticides and the presence or absence of disease in humans from eating food not grown with pesticides. As part of the research project, O hires a consultant who prepares a ''fact sheet'' which calls for the curtailment of the use of pesticides and which addresses itself to the merits of several specific legislative proposals to curtail the use of pesticides in raising crops which are currently pending before State legislatures. The ''fact sheet'' presents reports of experimental evidence tending to support its conclusions but omits any reference to reports of experimental evidence tending to dispute its conclusions. O distributes 10,000 copies to citizens' groups. Expenditures by O in connection with this work of the consultant are not within the exception for nonpartisan analysis, study, or research.

Example 4. P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example 5. X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

Example 6. Assume the same facts as Example (2), except that, instead of issuing a report, X presents within a period of 6 consecutive months a two-program television series relating to the pesticide issue. The first program contains information, arguments, and conclusions favoring legislation to restrict the use of pesticides. The second program contains information, arguments, and conclusions opposing legislation to restrict the use of pesticides. The programs are broadcast within 6 months of each other during commensurate periods of prime time. X's programs are within the exception for nonpartisan analysis, study, or research. Although neither program individually could be regarded as nonpartisan, the series of two programs constitutes a balanced presentation.

Example 7. Assume the same facts as Example (6), except that X arranged for televising the program favoring legislation to restrict the use of pesticides at 8 p.m. on a Thursday evening and for televising the program opposing such legislation at 7 a.m. on a Sunday morning. X's presentation is not within the exception for nonpartisan analysis, study, or research, since X disseminated its information in a manner prejudicial to one side of the legislative controversy.

Example 8. Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example 9. Assume the same facts as in Example (8), except that, after stating support

for the pending bill, the study concludes: ''You should write to the undecided committee members to support this crucial bill.'' The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example 10. Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in § 53.4945–2(d)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of §§ 53.4945–2(D)(1)(v) and 56.4911–2(b)(2)(v)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. Thus, the expenditures for preparing and mailing both the report and the letter are taxable expenditures under section 4945.

Example 11. Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications, and are thus taxable expenditures under section 4945.

Example 12. Organization M pays for a bumper sticker that reads: ''STOP ABORTION: Vote *NO* on Prop. X!'' M also pays for a 30-second television advertisement and a billboard that similarly advocate opposition to Prop. X. In light of the limited scope of the communications, none of the communications is within the exception for nonpartisan analysis, study or research. First, none of the communications rises to the level of analysis, study or research. Second, none of the communications is nonpartisan because none contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. Thus, each communication is a lobbying communication.

(2) *Technical advice or assistance*—(i) *In general.* Amounts paid or incurred in connection with providing technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either of the foregoing, in response to a written request by such body, committee, or subdivision do not constitute taxable expenditures for purposes of this section. Under this exception, the request for assistance or advice must be made in the name of the requesting governmental body, committee or subdivision rather than an individual member thereof. Similarly, the response to such request must be available to every member of the requesting body, committee or subdivision. For example, in the case of a written response to a request for technical advice or assistance from a congressional committee, the response will be considered available to every member of the requesting committee if the response is submitted to the person making such request in the name of the committee and it is made clear that the response is for the use of all the members of the committee.

(ii) *Nature of technical advice or assistance.* ''Technical advice or assistance'' may be given as a result of knowledge

or skill in a given area. Because such assistance or advice may be given only at the express request of a governmental body, committee or subdivision, the oral or written presentation of such assistance or advice need not qualify as nonpartisan analysis, study or research. The offering of opinions or recommendations will ordinarily qualify under this exception only if such opinions or recommendations are specifically requested by the governmental body, committee or subdivision or are directly related to the materials so requested.

(iii) *Examples*. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A congressional committee is studying the feasibility of legislation to provide funds for scholarships to U.S. students attending schools abroad. X, a private foundation which has engaged in a private scholarship program of this type, is asked, in writing, by the committee to describe the manner in which it selects candidates for its program. X's response disclosing its methods of selection constitutes technical advice or assistance.

Example 2. Assume the same facts as Example (1), except that X's response not only includes a description of its own grant-making procedures, but also its views regarding the wisdom of adopting such a program. Since such views are directly related to the subject matter of the request for technical advice or assistance, expenditures paid or incurred with respect to the presentation of such views would not constitute taxable expenditures. However, expenditures paid or incurred with respect to a response which is not directly related to the subject matter of the request for technical advice or assistance would constitute taxable expenditures unless the presentation can qualify as the making available of nonpartisan analysis, study or research.

Example 3. Assume the same facts as Example (1), except that X is requested, in addition, to give any views it considers relevant. A response to this request giving opinions which are relevant to the committee's consideration of the scholarship program but which are not necessarily directly related to X's scholarship program, such as discussions of alternative scholarships programs and their relative merits, would qualify as ''technical advice or assistance'', and expenditures paid or incurred with respect to such response would not constitute taxable expenditures.

Example 4. A, an official of the State Department, makes a written request in his official capacity for information from foundation Y relating to the economic development of country M and for the opinions of Y as to the proper position of the United States in pending negotiations with M concerning a proposed treaty involving a program of economic and technical aid to M. Y's furnishing of such information and opinions constitutes technical advice or assistance.

Example 5. In response to a telephone inquiry from Senator X's staff, organization B sends Senator X a report concluding that the Senate should not advise and consent to the nomination of Z to serve as a Supreme Court Justice. Because the request was not in writing, and also because the request was not from the Senate itself or from a committee or subcommittee, B's report is not within the scope of the exception for responses to requests for technical advice. Accordingly, B's report is a lobbying communication unless the report is within the scope of the exception for nonpartisan analysis, study or research.

Example 6. Assume the same facts as in Example (5), except that B's report is sent in response to a written request that Senator X sends to B. The request from Senator X is a request from the Senator as an individual member of the Senate rather than from the Senate itself or from a committee or subcommittee. Accordingly, B's report is not within the scope of the exception for responses to requests for technical advice and is a lobbying conmmunication unless the report is within the scope of the exception for nonpartisan analysis, study or research.

Example 7. Assume the same facts as in Example (6), except that B's report is sent in response to a written request from the Senate committee that is considering the nomination for an evaluation of the nominee's legal writings and a recommendation as to whether the candidate is or is not qualified to serve on the Supreme Court. The report is within the scope of the exception for responses to requests for technical advice and is not a lobbying communication.

(3) *Decisions affecting the powers, duties, etc., of a private foundation*—(i) *In general*. Paragraph (c) of this section does not apply to any amount paid or incurred in connection with an appearance before, or communication with, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to such foundation. Under this exception, a foundation may communicate with the entire legislative body, committees or subcommittees of such legislative body, individual congressmen or legislators,

members of their staffs, or representatives of the executive branch, who are involved in the legislative process, if such communication is limited to the prescribed subjects. Similarly, the foundation may make expenditures in order to initiate legislation if such legislation concerns only matters which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to such foundation.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A bill is being considered by Congress which would, if enacted, restrict the power of a private foundation to engage in transactions with certain related persons. Under the proposed bill a private foundation would lose its exemption from taxation if it engages in such transactions. W, a private foundation, writes to the congressional committee considering the bill, arguing that the enactment of such a bill would not be advisable, and subsequently appears before such committee to make its arguments. In addition, W requests that the congressional committee consider modification of the 2 percent de minimis rule of section 4943(c) (2) (C). Expenditures paid or incurred with respect to such submissions do not constitute taxable expenditures since they are made with respect to a possible decision of Congress which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation.

Example 2. A bill being considered in a State legislature is designed to implement the requirements of section 508(e) of the Internal Revenue Code of 1954. Under such section, a private foundation is required to make certain amendments to its governing instrument. X, a private foundation, makes a submission to the legislature which proposes alternative measures which might be taken in lieu of the proposed bill. X also arranges to have its president contact certain State legislators with regard to this bill. Expenditures paid or incurred in making such submission and in contacting the State legislators do not constitute taxable expenditures since they are made with respect to a possible decision of such State legislature which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation.

Example 3. A bill is being considered by a State legislature under which the State would assume certain responsibilities for nursing care of the aged. Y, a private foundation which hitherto has engaged in such activities, appears before the State legislature and contends that such activities can be better performed by privately supported organizations. Expenditures paid or incurred with respect to such appearance are not made with respect to possible decisions of the State legislature which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation, but rather merely affect the scope of the private foundation's future activities.

Example 4. A State legislature is considering the annual appropriations bill. Z, a private foundation which had hitherto performed contract research for the State, appears before the appropriations committee in order to attempt to persuade the committee of the advisability of continuing the program. Expenditures paid or incurred with respect to such appearance are not made with respect to possible decisions of the State legislature which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation, but rather merely affect the scope of the private foundation's future activities.

(4) *Examination and discussions of broad social, economic, and similar problems.* Examinations and discussions of broad social, economic, and similar problems are neither direct lobbying communications under § 56.4911–2(b)(1) nor grass roots lobbying communications under § 56.4911–2(b)(2) even if the problems are of the type with which government would be expected to deal ultimately. Thus, under §§ 56.4911–2(b)(1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation. For example, this paragraph (d)(4) excludes from grass roots lobbying under § 56.4911(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the

discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972; 37 FR 23918, Nov. 11, 1972, as amended by T.D. 8308, 55 FR 35594, Aug. 31, 1990]

§ 53.4945–3 Influencing elections and carrying on voter registration drives.

(a) *Expenditures to influence elections or carry on voter registration drives*—(1) *In general.* Under section 4945(d) (2), the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive, unless such amount is paid or incurred by an organization described in section 4945(f). However, for treatment of nonearmarked grants to public organizations, see § 53.4945–2(a) (5) and for treatment of certain earmarked grants to organizations described in section 4945(f), see paragraph (b) (2) of this section.

(2) *Influencing the outcome of a specific public election.* For purposes of this section, an organization shall be considered to be influencing the outcome of any specific public election if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The term *candidate for public office* means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State or local. Activities which constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to:

(i) Publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to such a candidate;

(ii) Paying salaries or expenses of campaign workers; and

(iii) Conducting or paying the expenses of conducting a voter-registration drive limited to the geographic area covered by the campaign.

(b) *Nonpartisan activities carried on by certain organizations*—(1) *In general.* If an organization meets the requirements described in section 4945(f), an amount paid or incurred by such organization shall not be considered a taxable expenditure even though the use of such amount is otherwise described in section 4945(d) (2). Such requirements are:

(i) The organization is described in section 501(c) (3) and exempt from taxation under section 501(a);

(ii) The activities of the organization are nonpartisan, are not confined to one specific election period, and are carried on in five or more States;

(iii) The organization expends at least 85 percent of its income directly for the active conduct (within the meaning of section 4942(j) (3) and the regulations thereunder) of the activities constituting the purpose or function for which it is organized and operated;

(iv) The organization receives at least 85 percent of its support (other than gross investment income as defined in section 509(e)) from exempt organizations, the general public, governmental units described in section 170(c) (1), or any combination of the foregoing; the organization does not receive more than 25 percent of its support (other than gross investment income) from any one exempt organization (for this purpose treating private foundations which are described in section 4946(a) (1) (H) with respect to each other as one exempt organization); and not more than half of the support of the organization is received from gross investment income; and

(v) Contributions to the organization for voter registration drives are not subject to conditions that they may be used only in specified States, possessions of the United States, or political subdivisions or other areas of any of the foregoing, or the District of Columbia, or that they may be used in only one specific election period.

(2) *Grants to section 4945(f) organizations.* If a private foundation makes a grant to an organization described in section 4945(f) (whether or not such grantee is a private foundation as defined in section 509(a)), such grant will not be treated as a taxable expenditure

under section 4945(d) (2) or (4). Even if a grant to such an organization is earmarked for voter registration purposes generally, such a grant will not be treated as a taxable expenditure under section 4945(d) (2) or (4) as long as such earmarking does not violate section 4945(f) (5).

(3) *Period for determining support*—(i) *In general.* The determination whether an organization meets the support test in section 4945(f) (4) for any taxable year is to be made by aggregating all amounts of support received by the organization during the taxable year and the immediately preceding four taxable years. However, the support received in any taxable year which begins before January 1, 1970, shall be excluded.

(ii) *New organizations and organizations with no preceding taxable years beginning after December 31, 1969.* Except as provided in subparagraph (4) of this paragraph, in the case of a new organization or an organization with no taxable years that begin after December 31, 1969, and immediately precede the taxable year in question, the requirements of the support test in section 4945(f)(4) will be considered as met for the taxable year if such requirements are met by the end of the taxable year.

(iii) *Organization with three or fewer preceding taxable years.* In the case of an organization which has been in existence for at least 1 but fewer than 4 preceding taxable years beginning after December 31, 1969, the determination whether such organization meets the requirements of the support test in section 4945(f)(4) for the taxable year is to be made by taking into account all the support received by such organization during the taxable year and during each preceding taxable year beginning after December 31, 1969.

(4) *Advance rulings.* An organization will be given an advance ruling that it is an organization described in section 4945(f) for its first taxable year of operation beginning after October 30, 1972, or for its first taxable year of operation beginning after December 31, 1969, if it submits evidence establishing that it can reasonably be expected to meet the tests under section 4945(f) for such taxable year. An organization which, pursuant to this subparagraph, has been treated as an organization described in section 4945(f) for a taxable year (without withdrawal of such treatment by notification from the Internal Revenue Service during such year), but which actually fails to meet the requirements of section 4945(f) for such taxable year, will not be treated as an organization described in section 4945(f) as of the first day of its next taxable year (for purposes of making any determination under the internal revenue laws with respect to such organization) and until such time as the organization does meet the requirements of section 4945(f). For purposes of section 4945, the status of grants or contributions with respect to grantors or contributors to such organization will not be affected until notice of change of status of such organization is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or was aware of, the fact that the organization did not satisfy section 4945(f) at the end of the taxable year with respect to which the organization had obtained an advance ruling or a determination letter that it was a section 4945(f) organization, or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as a section 4945(f) organization.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972; 37 FR 23918, Nov. 11, 1972]

§ 53.4945–4 Grants to individuals.

(a) *Grants to individuals*—(1) *In general.* Under section 4945(d) (3) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual unless the grant satisfies the requirements of section 4945(g). Grants to individuals which are not taxable expenditures because made in accordance with the requirements of section 4945(g) may result in the imposition of excise taxes under other provisions of chapter 42.

(2) *''Grants'' defined.* For purposes of section 4945, the term ''grants'' shall include, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes, and awards. Grants

shall also include loans for purposes described in section 170(c) (2) (B) and ''program related investments'' (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation). Similarly, ''grants'' include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations. Conversely, ''grants'' do not ordinarily include salaries or other compensation to employees. For example, ''grants'' do not ordinarily include educational payments to employees which are includible in the employees' incomes pursuant to section 61. In addition, ''grants'' do not ordinarily include payments (including salaries, consultants' fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.

(3) *Requirements for individual grants*—(i) *Grants for other than section 4945(d)(3) purposes.* A grant to an individual for purposes other than those described in section 4945(d) (3) is not a taxable expenditure within the meaning of section 4945(d) (3). For example, if a foundation makes grants to indigent individuals to enable them to purchase furniture, such grants are not taxable expenditures within the meaning of section 4945(d) (3) even if the requirements of section 4945(g) are not met.

(ii) *Grants for section 4945(d) (3) purposes.* Under section 4945(g), a grant to an individual for travel, study, or other similar purposes is not a ''taxable expenditure'' only if:

(*a*) The grant is awarded on an objective and nondiscriminatory basis (within the meaning of paragraph (b) of this section);

(*b*) The grant is made pursuant to a procedure approved in advance by the Commissioner; and

(*c*) It is demonstrated to the satisfaction of the Commissioner that:

(*1*) The grant constitutes a scholarship or fellowship grant which is excluded from gross income under section 117(a) and is to be utilized for study at an educational institution described in section 151(e) (4);

(*2*) The grant constitutes a prize or award which is excluded from gross income under section 74(b), and the recipient of such prize or award is selected from the general public (within the meaning of section 4941(d) (2) (G) (i) and the regulations thereunder); or

(*3*) The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

If a grant is made to an individual for a purpose described in section 4945(g) (3) and such grant otherwise meets the requirements of section 4945(g), such grant shall not be treated as a taxable expenditure even if it is a scholarship or a fellowship grant which is not excludable from income under section 117 or if it is a prize or award which is includible in income under section 74.

(iii) *Renewals.* A renewal of a grant which satisfied the requirements of subdivision (ii) of this subparagraph shall not be treated as a grant to an individual which is subject to the requirements of this section, if:

(*a*) The grantor has no information indicating that the original grant is being used for any purpose other than that for which it was made,

(*b*) Any reports due at the time of the renewal decision pursuant to the terms of the original grant have been furnished, and

(*c*) Any additional criteria and procedures for renewal are objective and nondiscriminatory.

For purposes of this section, an extension of the period over which a grant is to be paid shall not itself be regarded as a grant or a renewal of a grant.

(4) *Certain designated grants*—(i) *In general.* A grant by a private foundation to another organization, which the grantee organization uses to make payments to an individual for purposes described in section 4945(d)(3), shall not be regarded as a grant by the private

foundation to the individual grantee if the foundation does not earmark the use of the grant for any named individual and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the individual grantee by the grantee organization. For purposes of this subparagraph, a grant described herein shall not be regarded as a grant by the foundation to an individual grantee even though such foundation has reason to believe that certain individuals would derive benefits from such grant so long as the grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

(ii) *Certain grants to ''public charities''.* A grant by a private foundation to an organization described in section 509(a)(1), (2), or (3), which the grantee organization uses to make payments to an individual for purposes described in section 4945(d)(3), shall not be regarded as a grant by the private foundation to the individual grantee (regardless of the application of subdivision (i) of this subparagraph) if the grant is made for a project which is to be undertaken under the supervision of the section 509(a) (1), (2), or (3) organization and such grantee organization controls the selection of the individual grantee. This subdivision shall apply regardless of whether the name of the individual grantee was first proposed by the private foundation, but only if there is an objective manifestation of the section 509(a), (1), (2), or (3) organization's control over the selection process, although the selection need not be made completely independently of the private foundation. For purposes of this subdivision, an organization shall be considered a section 509(a)(1) organization if it is treated as such under subparagraph (4) of § 53.4945–5(a).

(iii) *Grants to governmental agencies.* If a private foundation makes a grant to an organization described in section 170(c)(1) (regardless of whether it is described in section 501(c)(3)) and such grant is earmarked for use by an individual for purposes described in section 4945(d)(3), such grant is not subject to the requirements of section 4945(d)(3) and (g) and this section (regardless of the application of subdivision (i) of this subparagraph) if the section 170(c)(1) organization satisfies the Commissioner in advance that its grant-making program:

(*a*) Is in furtherance of a purpose described in section 170(c)(2)(B),

(*b*) Requires that the individual grantee submit reports to it which would satisfy paragraph (c)(3) of this section, and

(*c*) Requires that the organization investigate jeopardized grants in a manner substantially similar to that described in paragraph (c)(4) of this section.

(iv) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. M, a university described in section 170(b)(1)(A)(ii), requests that P, a private foundation, grant it $100,000 to enable M to obtain the services of a particular scientist for a research project in a special field of biochemistry in which he has exceptional qualifications and competence. P, after determining that the project deserves support, makes the grant to M to enable it to obtain the services of this scientist. M is authorized to keep the funds even if it is unsuccessful in attempting to employ the scientist. Under these circumstances P will not be treated as having made a grant to the individual scientist for purposes of section 4945(d)(3) and (g), since the requirements of subdivision (i) of this subparagraph have been satisfied. Even if M were not authorized to keep the funds if it is unsuccessful in attempting to employ the scientist, P would not be treated as having made a grant to the individual scientist for purposes of section 4945(d)(3) and (g), since it is clear from the facts and circumstances that the selection of the particular scientist was made by M and thus the requirements of subdivision (ii) of this subparagraph would have been satisfied.

Example 2. Assume the same facts as Example (1), except that there are a number of scientists who are qualified to administer the research project, P suggests the name of the particular scientist to be employed by M, and M is not authorized to keep the funds if it is unsuccessful in attempting to employ the particular scientist. For purposes of section 4945(d)(3) and (g), P will be treated as having made a grant to the individual scientist whose name it suggested, since it is clear from the facts and circumstances that selection of the particular scientist was made by P.

Example 3. X, a private foundation, is aware of the exceptional research facilities at Y University, an organization described in

section 170(b)(1)(A)(ii). Officials of X approach officials of Y with an offer to give Y a grant of $100,000 if Y will engage an adequately qualified physicist to conduct a specific research project. Y's officials accept this proposal, and it is agreed that Y will administer the funds. After examining the qualifications of several research physicists, the officials of Y agree that A, whose name was first suggested by officials of X and who first suggested the specific research project to X, is uniquely qualified to conduct the project. X's grant letter provides that X has the right to renegotiate the terms of the grant if there is a substantial deviation from such terms, such as breakdown of Y's research facilities or termination of the conduct of the project by an adequately qualified physicist. Under these circumstances, X will not be treated as having made a grant to A for purposes of section 4945(d)(3) and (g), since the requirements of subdivision (ii) of this subparagraph have been satisfied.

Example 4. Professor A, a scholar employed by University Y, an organization described in section 170(b)(1)(A)(ii), approaches Foundation X to determine the availability of grant funds for a particular research project supervised or conducted by Professor A relevant to the program interests of Foundation X. After learning that Foundation X would be willing to consider the project if University Y were to submit the project to X, Professor A submits his proposal to the appropriate administrator of University Y. After making a determination that it should assume responsibility for the project, that Professor A is qualified to conduct the project, and that his participation would be consistent with his other faculty duties, University Y formally adopts the grant proposal and submits it to Foundation X. The grant is made to University Y which, under the terms of the grant, is responsible for the expenditure of the grant funds and the grant project. In such a case, and even if Foundation X retains the right to renegotiate the terms of the grant if the project ceases to be conducted by Professor A, the grant shall not be regarded as a grant by Foundation X to Professor A since University Y has retained control over the selection process within the meaning of subdivision (ii) of this subparagraph.

(5) *Earmarked grants to individuals.* A grant by a private foundation to an individual, which meets the requirements of section 4945(d)(3) and (g), is a taxable expenditure by such foundation under section 4945(d) only if:

(i) The grant is earmarked to be used for any activity described in section 4945(d) (1), (2), or (5), or is earmarked to be used in a manner which would violate section 4945(d) (3) or (4),

(ii) There is an agreement, oral or written, whereby such grantor foundation may cause the grantee to engage in any such prohibited activity and such grant is in fact used in a manner which violates section 4945(d), or

(iii) The grant is made for a purpose other than a purpose described in section 170(c)(2)(B).

For purposes of this subparagraph, a grant by a private foundation is earmarked if such grant is given pursuant to an agreement, oral or written, that the grant will be used for specific purposes.

(b) *Selection of grantees on ''an objective and nondiscriminatory basis''*—(1) *In general.* For purposes of this section, in order for a foundation to establish that its grants to individuals are made on an objective and nondiscriminatory basis, the grants must be awarded in accordance with a program which, if it were a substantial part of the foundation's activities, would be consistent with:

(i) The existence of the foundation's exempt status under section 501(c)(3);

(ii) The allowance of deductions to individuals under section 170 for contributions to the granting foundation; and

(iii) The requirements of subparagraphs (2), (3), and (4) of this paragraph.

(2) *Candidates for grants.* Ordinarily, selection of grantees on an objective and nondiscriminatory basis requires that the group from which grantees are selected be chosen on the basis of criteria reasonably related to the purposes of the grant. Furthermore, the group must be sufficiently broad so that the giving of grants to members of such group would be considered to fulfill a purpose described in section 170(c)(2)(B). Thus, ordinarily the group must be sufficiently large to constitute a charitable class. However, selection from a group is not necessary where taking into account the purposes of the grant, one or several persons are selected because they are exceptionally qualified to carry out these purposes or it is otherwise evident that the selection is particularly calculated to effectuate the charitable purpose of the grant rather than to benefit particular persons or a particular class of persons.

Therefore, consistent with the requirements of this subparagraph, the foundation may impose reasonable restrictions on the group of potential grantees. For example, selection of a qualified research scientist to work on a particular project does not violate the requirements of section 4945(d)(3) merely because the foundation selects him from a group of three scientists who are experts in that field.

(3) *Selection from within group of potential grantees.* The criteria used in selecting grant recipients from the potential grantees should be related to the purpose of the grant. Thus, for example, proper criteria for selecting scholarship recipients might include (but are not limited to) the following: Prior academic performance; performance on tests designed to measure ability and aptitude for college work; recommendations from instructors; financial need; and the conclusions which the selection committee might draw from a personal interview as to the individual's motivation, character, ability, and potential.

(4) *Persons making selections.* The person or group of persons who select recipients of grants should not be in a position to derive a private benefit, directly or indirectly, if certain potential grantees are selected over others.

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

Example 1. X company employs 100,000 people of whom 1,000 are classified by the company as executives. The company has organized the X company foundation which, as its sole activity, provides 100 4-year college scholarships per year for children of the company's employees. Children of all employees (other than disqualified persons with respect to the foundation) who have worked for the X company for at least 2 years are eligible to apply for these scholarships. In previous years, the number of children eligible to apply for such scholarships has averaged 2,000 per year. Selection of scholarship recipients from among the applicants is made by three prominent educators, who have no connection (other than as members of the selection committee) with the company, the foundation or any of the employees of the company. The selections are made on the basis of the applicants' prior academic performance, performance on certain tests designed to measure ability and aptitude for college work, and financial need. No disproportionate number of scholarships has been granted to relatives of executives of X company. Under these circumstances, the operation of the scholarship program by the X company foundation: (1) Is consistent with the existence of the foundation's exempt status under section 501(c) (3) and with the allowance of deductions under section 170 for contributions to the foundation; (2) utilizes objective and nondiscriminatory criteria in selecting scholarship recipients from among the applicants; and (3) utilizes a selection committee which appears likely to make objective and nondiscriminatory selections of grant recipients.

Example 2. Assume the same facts as Example (1), except that the foundation establishes a program to provide 20 college scholarships per year for members of a certain ethnic minority. All members of this minority group (other than disqualified persons with respect to the foundation) living in State Z are eligible to apply for these scholarships. It is estimated that at least 400 persons will be eligible to apply for these scholarships each year. Under these circumstances, the operation of this scholarship program by the foundation: (1) Is consistent with the existence of the foundation's exempt status under section 501(c)(3) and with the allowance of deductions under section 170 for contributions to the foundation; (2) utilizes objective and nondiscriminatory criteria in selecting scholarship recipients from among the applicants; and (3) utilizes a selection committee which appears likely to make objective and nondiscriminatory selections of grant recipients.

(c) *Requirements of a proper procedure*—(1) *In general.* Section 4945(g) requires that grants to individuals must be made pursuant to a procedure approved in advance. To secure such approval, a private foundation must demonstrate to the satisfaction of the Commissioner that:

(i) Its grant procedure includes an objective and nondiscriminatory selection process (as described in paragraph (b) of this section);

(ii) Such procedure is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance; and

(iii) The foundation plans to obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance.

No single procedure or set of procedures is required. Procedures may vary depending upon such factors as the size

of the foundation, the amount and purpose of the grants and whether one or more recipients are involved.

(2) *Supervision of scholarship and fellowship grants.* Except as provided in subparagraph (5) of this paragraph, with respect to any scholarship or fellowship grants, a private foundation must make arrangements to receive a report of the grantee's courses taken (if any) and grades received (if any) in each academic period. Such a report must be verified by the educational institution attended by the grantee and must be obtained at least once a year. In cases of grantees whose study at an educational institution does not involve the taking of courses but only the preparation of research papers or projects, such as the writing of a doctoral thesis, the foundation must receive a brief report on the progress of the paper or project at least once a year. Such a report must be approved by the faculty member supervising the grantee or by another appropriate university official. Upon completion of a grantee's study at an educational institution, a final report must also be obtained.

(3) *Grants described in section 4945(g)(3).* With respect to a grant made under section 4945(g)(3), the private foundation shall require reports on the use of the funds and the progress made by the grantee toward achieving the purposes for which the grant was made. Such reports must be made at least once a year. Upon completion of the undertaking for which the grant was made, a final report must be made describing the grantee's accomplishments with respect to the grant and accounting for the funds received under such grant.

(4) *Investigation of jeopardized grants.* (i) Where the reports submitted under this paragraph or other information (including the failure to submit such reports) indicates that all or any part of a grant is not being used in furtherance of the purposes of such grant, the foundation is under a duty to investigate. While conducting its investigation, the foundation must withhold further payments to the extent possible until any delinquent reports required by this paragraph have been submitted and where required by subdivision (ii) or (iii) of this subparagraph.

(ii) In cases in which the grantor foundation determines that any part of a grant has been used for improper purposes and the grantee has not previously diverted grant funds to any use not in furtherance of a purpose specified in the grant, the foundation will not be treated as having made a taxable expenditure solely because of the diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps either to recover the grant funds or to insure the restoration of the diverted funds and the dedication (consistent with the requirements of (*b*) (*1*) and (*2*) of this subdivision) of other grant funds held by the grantee to the purposes being financed by the grant, and

(*b*) Withholds any further payments to the grantee after the grantor becomes aware that a diversion may have taken place (hereinafter referred to as ''further payments'') until it has:

(*1*) Received the grantee's assurances that future diversions will not occur, and

(*2*) Required the grantee to take extraordinary precaution to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision the amount of the taxable expenditure shall be the amount of the diversion plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision but not the requirements of (b) of this subdivision, the amount of the taxable expenditure shall be the amount of such further payments.

(iii) In cases where a grantee has previously diverted funds received from a grantor foundation, and the grantor foundation determines that any part of a grant has again been used for improper purposes, the foundation will not be treated as having made a taxable expenditure solely by reason of such diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps to recover the grant funds or to insure the restoration of the funds and the dedication (consistent with the requirements of (*b*) (*2*) and (*3*) of this subdivision) of other grant funds held by the grantee to the purposes being financed by the grant, and

(*b*) Withholds further payments until:

(*1*) Such funds are in fact so recovered or restored,

(*2*) It has received the grantee's assurances that future diversions will not occur, and

(*3*) It requires the grantee to take extraordinary precautions to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision, the amount of the taxable expenditure shall be the amount of the diversion plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision, but fails to withhold further payments until the requirements of (*b*) of this subdivision are met, the amount of the taxable expenditure shall be the amount of such further payments.

(iv) The phrase ''all reasonable and appropriate steps'' in subdivisions (ii) and (iii) of this subparagraph includes legal action where appropriate but need not include legal action if such action would in all probability not result in the satisfaction of execution on a judgment.

(5) *Supervision of certain scholarship and fellowship grants.* Subparagraphs (2) and (4) of this paragraph shall be considered satisfied with respect to scholarship or fellowship grants under the following circumstances:

(i) The scholarship or fellowship grants are described in section 4945(g)(1);

(ii) The grantor foundation pays the scholarship or fellowship grants to an educational institution described in section 151(e) (4); and

(iii) Such educational institution agrees to use the grant funds to defray the recipient's expenses or to pay the funds (or a portion thereof) to the recipient only if the recipient is enrolled at such educational institution and his standing at such educational institution is consistent with the purposes and conditions of the grant.

(6) *Retention of records.* A private foundation shall retain records pertaining to all grants to individuals for purposes described in section 4945(d)(3). Such records shall include:

(i) All information the foundation secures to evaluate the qualification of potential grantees;

(ii) Identification of grantees (including any relationship of any grantee to the foundation sufficient to make such grantee a disqualified person of the private foundation within the meaning of section 4946(a) (1));

(iii) Specification of the amount and purpose of each grant; and

(iv) The follow-up information which the foundation obtains in complying with subparagraphs (2), (3), and (4) of this paragraph.

(7) *Example.* The provisions of paragraphs (b) and (c) of this section may be illustrated by the following example:

Example. The X foundation grants 10 scholarships each year to graduates of high schools in its area to permit the recipients to attend college. It makes the availability of its scholarships known by oral or written communications each year to the principals of three major high schools in the area. The foundation obtains information from each high school on the academic qualifications, background, and financial need of applicants. It requires that each applicant be recommended by two of his teachers or by the principal of his high school. All application forms are reviewed by the foundation officer responsible for making the awards and scholarships are granted on the basis of the academic qualifications and financial need of the grantees. The foundation obtains annual reports on the academic performance of the scholarship recipient from the college or university which he attends. It maintains a file on each scholarship awarded, including the original application, recommendations, a record of the action taken on the application, and the reports on the recipient from the institution which he attends. The described procedures of the X foundation for the making of grants to individuals qualify for Internal Revenue Service approval under

section 4945(g). Furthermore, if the X foundation's scholarship program meets the requirements of subparagraph (5) of this paragraph, X foundation will not have to obtain reports on the academic performance of the scholarship recipients.

(d) *Submission of grant procedure*—(1) *Contents of request for approval of grant procedures*. A request for advance approval of a foundation's grant procedures must fully describe the foundation's procedures for awarding grants and for ascertaining that such grants are used for the proper purposes. The approval procedure does not contemplate specific approval of particular grant programs but instead one-time approval of a system of standards, procedures, and follow-up designed to result in grants which meet the requirements of section 4945(g). Thus, such approval shall apply to a subsequent grant program as long as the procedures under which it is conducted do not differ materially from those described in the request to the Commissioner. The request must contain the following items:

(i) A statement describing the selection process. Such statement shall be sufficiently detailed for the Commissioner to determine whether the grants are made on an objective and nondiscriminatory basis under paragraph (b) of this section.

(ii) A description of the terms and conditions under which the foundation ordinarily makes such grants, which is sufficient to enable the Commissioner to determine whether the grants awarded under such procedures would meet the requirements of paragraph (1), (2), or (3) of section 4945(g).

(iii) A detailed description of the private foundation's procedure for exercising supervision over grants, as described in paragraph (c) (2) and (3) of this section.

(iv) A description of the foundation's procedures for review of grantee reports, for investigation where diversion of grant funds from their proper purposes is indicated, and for recovery of diverted grant funds, as described in paragraph (c) (4) of this section.

(2) *Place of submission*. Request for approval of grant procedures shall be submitted to the District Director.

(3) *Internal Revenue Service action on request for approval of grant procedures*. The 45th day after a request for approval of grant procedures has been properly submitted to the Internal Revenue Service, the organization has not been notified that such procedures are not acceptable, such procedures shall be considered as approved from the date of submission until receipt of actual notice from the Internal Revenue Service that such procedures do not meet the requirements of this section. If a grant to an individual for a purpose described in section 4945(d) (3) is made after notification to the organization by the Internal Revenue Service that the procedures under which the grant is made are not acceptable, such grant is a taxable expenditure under this section.

(e) *Effective dates*—(1) *In general*. This section shall apply to all grants to individuals for travel, study, or other similar purposes which are made by private foundations more than 90 days after October 30, 1972.

(2) *Transitional rules*—(i) *Grants committed prior to January 1, 1970*. Section 4945(d) (3) and (g) and this section shall not apply to a grant for section 170(c) (2) (B) purposes made on or after January 1, 1970, if the grant was made pursuant to a commitment entered into prior to such date, but only if such commitment was made in accordance with the foundation's usual practices and is reasonable in amount in light of the purposes of the grant. For purposes of this subdivision, a commitment will be considered entered into prior to January 1, 1970, if prior to such date, the amount and nature of the payments to be made and the name of the payee were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee in writing.

(ii) *Grants awarded on or after January 1, 1970*. In the case of a grant awarded on or after January 1, 1970, but prior to the expiration of 90 days after October 30, 1972, and paid within 48 months after the award of such grant, the requirements of section 4945(g) that an individual grant be awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in

advance by the Commissioner will be deemed satisfied if the grantor utilizes any procedure in good faith in awarding a grant to an individual which, in fact, is reasonably calculated to provide objectivity and nondiscrimination in the awarding of such grant and to result in a grant which complies with the conditions of section 4945(g) (1), (2), or (3).

§ 53.4945–5 Grants to organizations.

(a) *Grants to nonpublic organizations*—(1) *In general.* Under section 4945(d)(4) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation as a grant to an organization (other than an organization described in section 509(a) (1), (2) or (3)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with section 4945(h). However, the granting foundation does not have to exercise expenditure responsibility with respect to amounts granted to organizations described in section 4945(f).

(2) *''Grants'' described.* For a description of the term ''grants'', see § 53.4945–4(a)(2).

(3) *Section 509(a) (1), (2), and (3) organizations.* See section 508(b) and the regulations thereunder for rules relating to when a grantor may rely on a potential grantee's characterization of its status as set forth in the notice described in section 508(b).

(4) *Certain ''public'' organizations.* For purposes of this section, an organization will be treated as a section 509(a)(1) organization if:

(i) It qualifies as such under paragraph (a) of § 1.509(a)–2 of this chapter;

(ii) It is an organization described in section 170(c)(1) or 511(a)(2)(B), even if it is not described in section 501(c)(3); or

(iii) It is a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive order under 22 U.S.C. 288, even if it is not described in section 501(c)(3).

However, any grant to an organization referred to in this subparagraph must be made exclusively for charitable purposes as described in section 170(c)(2)(B).

(5) *Certain foreign organizations.* If a private foundation makes a grant to a foreign organization which does not have a ruling or determination letter that it is an organization described in section 509(a)(1), (2), or (3), such grant will not be treated as a grant made to an organization other than an organization described in section 509(a)(1), (2), or (3) if the grantor private foundation has made a good faith determination that the grantee organization is an organization described in section 509(a)(1), (2), or (3). Such a ''good faith determination'' ordinarily will be considered as made where the determination is based on an affidavit of the grantee organization or an opinion of counsel (of the grantor or the grantee) that the grantee is an organization described in section 509(a)(1), (2), or (3). Such an affidavit or opinion must set forth sufficient facts concerning the operations and support of the grantee for the Internal Revenue Service to determine that the grantee would be likely to qualify as an organization described in section 509(a) (1), (2), or (3). See paragraphs (b)(5) and (b)(6) of this section for other special rules relating to foreign organizations.

(6) *Certain earmarked grants*—(i) *In general.* A grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant. For purposes of this subdivision, a grant described herein shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

(ii) *To governmental agencies.* If a private foundation makes a grant to an organization described in section 170(c)(1) and such grant is earmarked for use by another organization, the granting foundation need not exercise expenditure responsibility with respect to such grant if the section 170(c)(1) organization satisfies the Commissioner in advance that:

(*a*) Its grant-making program is in furtherance of a purpose described in section 170(c)(2)(B), and

(*b*) The section 170(c)(1) organization exercises ''expenditure responsibility'' in a manner that would satisfy this section if it applied to such section 170(c)(1) organization.

However, with respect to such grant, the granting foundation must make the reports required by section 4945(h)(3) and paragraph (d) of this section, unless such grant is earmarked for use by an organization described in section 509(a) (1), (2), or (3).

(b) *Expenditure responsibility*—(1) *In general.* A private foundation is not an insurer of the activity of the organization to which it makes a grant. Thus, satisfaction of the requirements of sections 4945(d)(4) and (h) and of subparagraph (3) or (4) of this paragraph, will ordinarily mean that the grantor foundation will not have violated section 4945(d) (1) or (2). A private foundation will be considered to be exercising ''expenditure responsibility'' under section 4945(h) as long as it exerts all reasonable efforts and establishes adequate procedures:

(i) To see that the grant is spent solely for the purpose for which made,

(ii) To obtain full and complete reports from the grantee on how the funds are spent, and

(iii) To make full and detailed reports with respect to such expenditures to the Commissioner.

In cases in which pursuant to paragraph (a)(6) of this section a grant is considered made to a secondary grantee rather than the primary grantee, the grantor foundation's obligation to obtain reports from the grantee pursuant to section 4945(h)(2) and this section will be satisfied if appropriate reports are obtained from the secondary grantee. For rules relating to expenditure responsibility with respect to transfers of assets described in section 507(b)(2), see section 507(b)(2) and the regulations thereunder.

(2) *Pre-grant inquiry*—(i) Before making a grant to an organization with respect to which expenditure responsibility must be exercised under this section, a private foundation should conduct a limited inquiry concerning the potential grantee. Such inquiry should be complete enough to give a reasonable man assurance that the grantee will use the grant for the proper purposes. The inquiry should concern itself with matters such as: (*a*) The identity, prior history and experience (if any) of the grantee organization and its managers; and (*b*) any knowledge which the private foundation has (based on prior experience or otherwise) of, or other information which is readily available concerning, the management, activities, and practices of the grantee organization. The scope of the inquiry might be expected to vary from case to case depending upon the size and purpose of the grant, the period over which it is to be paid, and the prior experience which the grantor has had with respect to the capacity of the grantee to use the grant for the proper purposes. For example, if the grantee has made proper use of all prior grants to it by the grantor and filed the required reports substantiating such use, no further pregrant inquiry will ordinarily be necessary. Similarly, in the case of an organization, such as a trust described in section 4947(a)(2), which is required by the terms of its governing instrument to make payments to a specified organization exempt from taxation under section 501(a), a less extensive pregrant inquiry is required than in the case of a private foundation possessing discretion with respect to the distribution of funds.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Officials of M, a newly established organization which is described in section 501(c)(4), request a grant from X foundation to be used for a proposed program to combat drug abuse by establishing neighborhood clinics in certain ghetto areas of a city. Before making a grant to M, X makes an inquiry concerning the identity, prior history and experience of the officials of M. X obtains information pertaining to the officials

of M from references supplied by these officials. Since one of the references indicated that A, an official of M, has an arrest record, police records are also checked and A's probation officer is interviewed.

The inquiry also shows M has no previous history of administering grants and that the officials of M have had no experience in administering programs of this nature. However, in the opinion of X's managers, M's officials (including A who appears to be fully rehabilitated after having been convicted of a narcotics violation several years ago) are well qualified to conduct this program since they are members of the communities in which the clinics are to be established and are more likely to be trusted by drug users in these communities than are outsiders. Under these circumstances X has complied with the requirements of this subparagraph and a grant to M for its proposed program will not be treated as a taxable expenditure solely because of the operation of this subparagraph.

Example 2. Foundation Y wishes to make a grant to foundation R for use in R's scholarship program. Y has made similar grants to R annually for the last several years and knows that R's managers have observed the terms of the previous grants and have made all requested reports with respect to such grants. No changes in R's management have occurred during the past several years. Under these circumstances, Y has enough information to have such assurance as a reasonable man would require that the grant to R will be used for proper purposes. Consequently, Y is under no obligation to make any further pregrant inquiry pursuant to this subparagraph.

Example 3. S foundation requests a grant from Z foundation for use in S's program of providing medical research fellowships. S has been engaged in this program for several years and has received large numbers of grants from other foundations. Z's managers know that the reputations of S and of S's officials are good. Z's managers also have been advised by managers of W foundation that W had recently made a grant to S and that W's managers were satisfied that such grant has been used for the purposes for which it was made. Under these circumstances Z has enough information to have such assurance as a reasonable man would require that the grant to S will be used for proper purposes. Consequently, Z is under no obligation to make any further pregrant inquiry pursuant to this subparagraph.

(3) *Terms of grants.* Except as provided in subparagraph (4) of this paragraph, in order to meet the expenditure responsibility requirements of section 4945(h), a private foundation must require that each grant to an organization, with respect to which expenditure responsibility must be exercised under this section, be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization. Such commitment must include an agreement by the grantee:

(i) To repay any portion of the amount granted which is not used for the purposes of the grant,

(ii) To submit full and complete annual reports on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant, except as provided in paragraph (c)(2) of this section,

(iii) To maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times, and

(iv) Not to use any of the funds:

(*a*) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1)),

(*b*) To influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive (within the meaning of section 4945(d)(2)),

(*c*) To make any grant which does not comply with the requirements of section 4945(d) (3) or (4), or

(*d*) To undertake any activity for any purpose other than one specified in section 170(c)(2)(B).

The agreement must also clearly specify the purposes of the grant. Such purposes may include contributing for capital endowment, for the purchase of capital equipment, or for general support provided that neither the grants nor the income therefrom may be used for purposes other than those described in section 170(c)(2)(B).

(4) *Terms of program-related investments.* In order to meet the expenditure responsibility requirements of section 4945(h), with regard to the making of a program-related investment (as defined in section 4944 and the regulations thereunder), a private foundation must require that each such investment with respect to which expenditure responsibility must be exercised under section 4945(d)(4) and (h) and this section be made subject to a written commitment

signed by an appropriate officer, director, or trustee of the recipient organization. Such commitment must specify the purpose of the investment and must include an agreement by the organization:

(i) To use all the funds received from the private foundation (as determined under paragraph (c)(3) of this section) only for the purposes of the investment and to repay any portion not used for such purposes, provided that, with respect to equity investments, such repayment shall be made only to the extent permitted by applicable law concerning distributions to holders of equity interests,

(ii) At least once a year during the existence of the program-related investment, to submit full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment,

(iii) To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times, and

(iv) Not to use any of the funds:

(*a*) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1)),

(*b*) To influence the outcome of any specific public election, or to carry on directly or indirectly, and voter registration drive (within the meaning of section 4945(d)(2)), or

(*c*) With respect to any recipient which is a private foundation (as defined in section 509(a)), to make any grant which does not comply with the requirements of section 4945 (d) (3) or (4).

(5) *Certain grants to foreign organizations.* With respect to a grant to a foreign organization (other than an organization described in section 509(a) (1), (2), or (3) or treated as so described pursuant to paragraph (a)(4) or (a)(5) of this section), subparagraph (3)(iv) or (4)(iv) of this paragraph shall be deemed satisfied if the agreement referred to in subparagraph (3) or (4) of this paragraph imposes restrictions on the use of the grant substantially equivalent to the limitations imposed on a domestic private foundation under section 4945(d). Such restrictions may be phrased in appropriate terms under foreign law or custom and ordinarily will be considered sufficient if an affidavit or opinion of counsel (of the grantor or grantee) is obtained stating that, under foreign law or custom, the agreement imposes restrictions on the use of the grant substantially equivalent to the restrictions imposed on a domestic private foundation under subparagraph (3) or (4) of this paragraph.

(6) *Special rules for grants by foreign private foundations.* With respect to activities in jurisdictions other than those described in section 170(c)(2)(A), the failure of a foreign private foundation which is described in section 4948(b) to comply with subparagraph (3) or (4) of this paragraph with respect to a grant to an organization shall not constitute an act or failure to act which is a prohibited transaction (within the meaning of section 4948(c)(2)).

(7) *Expenditure responsibility with respect to certain transfers of assets described in section 507*—(i) *Transfers of assets described in section 507(b)(2).* For rules relating to the extent to which the expenditure responsibility rules contained in section 4945 (d)(4) and (h) and this section apply to transfers of assets described in section 507(b)(2), see §§ 1.507–3(a)(7), 1.507–3 (a)(8)(ii)(*f*), and 1.507–3(a)(9) of this chapter.

(ii) *Certain other transfers of assets.* For rules relating to the extent to which the expenditure responsibility rules contained in section 4945 (d)(4) and (h) and this section apply to certain other transfers of assets described in § 1.507–3(b) of this chapter, see § 1.507–3(b) of this chapter.

(8) *Restrictions on grants (other than program-related investments) to organizations not described in section 501(c)(3).* For other restrictions on certain grants (other than program-related investments) to organizations which are not described in section 501(c)(3), see § 53.4945–6(c).

(c) *Reports from grantees*—(1) *In general.* In the case of grants described in section 4945(d)(4), except as provided in subparagraph (2) of this paragraph, the

granting private foundation shall require reports on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made. The grantee shall make such reports as of the end of its annual accounting period within which the grant or any portion thereof is received and all such subsequent periods until the grant funds are expended in full or the period of the grantee for which such reports shall be furnished to the grantor within a reasonable period of time after the close of the annual accounting period of the grantee for which such reports are made. Within a reasonable period of time after the close of its annual accounting period during which the use of the grant funds is completed, the grantee must make a final report with respect to all expenditures made from such funds (including salaries, travel, and supplies), and indicating the progress made toward the goals of the grant. The grantor need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability.

(2) *Capital endowment grants to exempt private foundations.* If a private foundation makes a grant described in section 4945(d)(4) to a private foundation which is exempt from taxation under section 501(a) for endowment, for the purchase of capital equipment, or for other capital purposes, the grantor foundation shall require reports from the grantee on the use of the principal and the income (if any) from the grant funds. The grantee shall make such reports annually for its taxable year in which the grant was made and the immediately succeeding 2 taxable years. Only if it is reasonably apparent to the grantor that, before the end of such second succeeding taxable year, neither the principal, the income from the grant funds, nor the equipment purchased with the grant funds has been used for any purpose which would result in liability for tax under section 4945(d), the grantor may then allow such reports to be discontinued.

(3) *Grantees' accounting and recordkeeping procedures.* (i) A private foundation grantee exempt from taxation under section 501(a) (or the recipient of a program-related investment) need not segregate grant funds physically nor separately account for such funds on its books unless the grantor requires such treatment of the grant funds. If such a grantee neither physically segregates grant funds nor establishes separate accounts on its books, grants received within a given taxable year beginning after December 31, 1969, shall be deemed, for purposes of section 4945, to be expended before grants received in a succeeding taxable year. In such case expenditures of grants received within any such taxable year shall be prorated among all such grants.

In accounting for grant expenditures, private foundations may make the necessary computations on a cumulative annual basis (or, where appropriate, as of the date for which the computations are made). The rules set forth in the preceding three sentences shall apply to the extent they are consistent with the available records of the grantee and with the grantee's treatment of qualifying distributions under section 4942(h) and the regulations thereunder. The records of expenditures, as well as copies of the reports submitted to the grantor, must be kept for at least 4 years after completion of the use of the grant funds.

(ii) For rules relating to accounting and recordkeeping requirements for grantees other than those described in subdivision (i) of this subparagraph, see §§ 53.4945–5(b)(8) and 53.4945–6(c).

(4) *Reliance on information supplied by grantee.* A private foundation exercising expenditure responsibility with respect to its grants may rely on adequate records or other sufficient evidence supplied by the grantee organization (such as a statement by an appropriate officer, director or trustee of such grantee organization) showing, to the extent applicable, the information which the grantor must report to the Internal Revenue Service in accordance with paragraph (d)(2) of this section.

(d) *Reporting to Internal Revenue Service by grantor*—(1) *In general.* To satisfy the reportmaking requirements of section 4945(h)(3), a granting foundation must provide the required information

on its annual information return, required to be filed by section 6033, for each taxable year with respect to each grant made during the taxable year which is subject to the expenditure responsibility requirements of section 4945(h). Such information must also be provided on such return with respect to each grant subject to such requirements upon which any amount or any report is outstanding at any time during the taxable year. However, with respect to any grant made for endowment or other capital purposes, the grantor must provide the required information only for any taxable year for which the grantor must require a report from the grantee under paragraph (c)(2) of this section. The requirements of this subparagraph with respect to any grant may be satisfied by submission with the foundation's information return of a report received from the grantee, if the information required by subparagraph (2) of this paragraph is contained in such report.

(2) *Contents of report*. The report required by this paragraph shall include the following information:

(i) The name and address of the grantee.

(ii) The date and amount of the grant.

(iii) The purpose of the grant.

(iv) The amounts expended by the grantee (based upon the most recent report received from the grantee).

(v) Whether the grantee has diverted any portion of the funds (or the income therefrom in the case of an endowment grant) from the purpose of the grant (to the knowledge of the grantor).

(vi) The dates of any reports received from the grantee.

(vii) The date and results of any verification of the grantee's reports undertaken pursuant to and to the extent required under paragraph (c)(1) of this section by the grantor or by others at the direction of the grantor.

(3) *Recordkeeping requirements*. In addition to the information included on the information return, a granting foundation shall make available to the Internal Revenue Service at the foundation's principal office each of the following items:

(i) A copy of the agreement covering each ''expenditure responsibility'' grant made during the taxable year.

(ii) A copy of each report received during the taxable year from each grantee on any ''expenditure responsibility'' grant, and

(iii) A copy of each report made by the grantor's personnel or independent auditors of any audits or other investigations made during the taxable year with respect to any ''expenditure responsibility'' grant.

(4) *Reports received after the close of grantor's accounting year*. Data contained in reports required by this paragraph, which reports are received by a private foundation after the close of its accounting year but before the due date of its information return for that year, need not be reported on such return, but may be reported on the grantor's information return for the year in which such reports are received from the grantee.

(e) *Violations of expenditure responsibility requirements*—(1) *Diversions by grantee*. (i) Any diversion of grant funds (including the income therefrom in the case of an endowment grant) by the grantee to any use not in furtherance of a purpose specified in the grant may result in the diverted portion of such grant being treated as a taxable expenditure of the grantor under section 4945(d)(4). However, for purposes of this section, the fact that a grantee does not use any portion of the grant funds as indicated in the original budget projection shall not be treated as a diversion if the use to which the funds are committed is consistent with the purpose of the grant as stated in the grant agreement and does not result in a violation of the terms of such agreement required to be included by paragraph (b)(3) or (b)(4) of this section.

(ii) In any event, a grantor will not be treated as having made a taxable expenditure under section 4945(d)(4) solely by reason of a diversion by the grantee, if the grantor has complied with subdivision (iii) (*a*) and (*b*) or (iv) (*a*) and (*b*) of this subparagraph, whichever is applicable.

(iii) In cases in which the grantor foundation determines that any part of

a grant has been used for improper purposes and the grantee has not previously diverted grant funds, the foundation will not be treated as having made a taxable expenditure solely by reason of the diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps either to recover the grant funds or to insure the restoration of the diverted funds and the dedication (consistent with the requirements of (*b*) (*1*) and (*2*) of this subdivision) of the other grant funds held by the grantee to the purposes being financed by the grant, and

(*b*) Withholds any further payments to the grantee after the grantor becomes aware that a diversion may have taken place (hereinafter referred to as ''further payments'') until it has:

(*1*) Received the grantee's assurances that future diversions will not occur, and

(*2*) Required the grantee to take extraordinary precautions to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision the amount of the taxable expenditure shall be the amount of the diversion (for example, the income diverted in the case of an endowment grant, or the rental value of capital equipment for the period of time for which diverted) plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision but not the requirements of (*b*) of this subdivision, the amount of the taxable expenditure shall be the amount of such further payments.

(iv) In cases where a grantee has previously diverted funds received from a grantor foundation, and the grantor foundation determines that any part of a grant has again been used for improper purposes, the foundation will not be treated as having made a taxable expenditure solely by reason of such diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps to recover the grant funds or to insure the restoration of the diverted funds and the dedication (consistent with the requirements of (*b*) (*2*) and (*3*) of this subdivision) of other grant funds held by the grantee to the purposes being financed by the grant, except that if, in fact, some or all of the diverted funds are not so restored or recovered, then the foundation must take all reasonable and appropriate steps to recover all of the grant funds, and

(*b*) Withholds further payments until:

(*1*) Such funds are in fact so recovered or restored,

(*2*) It has received the grantee's assurances that future diversions will not occur, and

(*3*) It requires the grantee to take extraordinary precautions to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision, the amount of the taxable expenditure shall be the amount of the diversion plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision, but fails to withhold further payments until the requirements of (*b*) of this subdivision are met, the amount of the taxable expenditure shall be the amount of such further payments.

(v) The phrase ''all reasonable and appropriate steps'' (as used in subdivisions (iii) and (iv) of this subparagraph) includes legal action where appropriate but need not include legal action if such action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Grantee's failure to make reports.* A failure by the grantee to make the reports required by paragraph (c) of this section (or the making of inadequate reports) shall result in the grant's being treated as a taxable expenditure by the grantor unless the grantor:

(i) Has made the grant in accordance with paragraph (b) of this section,

(ii) Has complied with the reporting requirements contained in paragraph (d) of this section,

(iii) Makes a reasonable effort to obtain the required report, and

(iv) Withholds all future payments on this grant and on any other grant to the same grantee until such report is furnished.

(3) *Violations by the grantor*. In addition to the situations described in subparagraphs (1) and (2) of this paragraph, a grant which is subject to the expenditure responsibility requirements of section 4945(h) will be considered a taxable expenditure of the granting foundation if the grantor:

(i) Fails to make a pregrant inquiry as described in paragraph (b)(2) of this section,

(ii) Fails to make the grant in accordance with a procedure consistent with the requirements of paragraph (b)(3) or (4) of this section, or

(iii) Fails to report to the Internal Revenue Service as provided in paragraph (d) of this section.

(f) *Effective dates*—(1) *In general*. This section shall apply to all grants which are subject to the expenditure responsibility requirements of section 4945(d)(4) and (h) and which are made by private foundations more than 90 days after October 30, 1972.

(2) *Transitional rules*—(i) *Certain grants awarded prior to May 27, 1969*. Section 4945(d)(4) and (h) and this section shall not apply to a grant to a private foundation which is not controlled, directly or indirectly, by the grantor foundation or one or more disqualified persons (as defined in section 4946) with respect to the grantor foundation, provided that such grant:

(*a*) Is made pursuant to a written commitment which was binding on May 26, 1969, and at all times thereafter,

(*b*) Is made for one or more of the purposes described in section 170(c)(2)(B), and

(*c*) Is to be paid out to such grantee foundation on or before December 31, 1974.

(ii) *Grants or expenditures committed prior to January 1, 1970*. Except as provided in paragraph (e)(2)(i) of § 53.4945–4, section 4945 shall not apply to a grant or an expenditure for section 170(c)(2)(B) purposes made on or after January 1, 1970, if the grant or expenditure was made pursuant to a commitment entered into prior to such date, but only if (in the case of a grant or an expenditure other than an unlimited general-purpose grant to an organization) such commitment is reasonable in amount in light of the purposes of the grant. For purposes of this subdivision, a commitment will be considered entered into prior to January 1, 1970, if prior to such date, the amount and nature of the payments to be made and the name of the payee were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee in writing.

(iii) *Grants awarded on or after January 1, 1970*. Paragraphs (b), (c), and (d) of this section shall not apply to grants awarded on or after January 1, 1970, but prior to the expiration of 90 days after October 30, 1972, if the grantor has made reasonable efforts, and has established adequate procedures such as a prudent man would adopt in managing his own property, to see that the grant is spent solely for the purpose for which made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such grant to the Commissioner. With respect to any return filed with the Internal Revenue Service before the expiration of 90 days after October 30, 1972, the grantor may treat reports which satisfy the requirements of the statement to be attached to Form 4720 for the year 1970 under ''Specific Instructions—Question B'' (items (1) through (5)) as satisfying the grantor reporting requirements with respect to ''expenditure responsibility'' grants. In the case of a private foundation required to file an annual return for a taxable year ending after January 1, 1970, and before December 31, 1970, the reporting requirements imposed by section 4945(h)(3) for such period shall be regarded as satisfied if such reports are made on the annual return for its first taxable year beginning after December 31, 1969.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972; 37 FR 23918, Nov. 10, 1972, as amended by T.D. 7233, 37 FR 28162, Dec. 21, 1972; T.D. 7290, 38 FR 31834, Nov. 19, 1973]

§ 53.4945–6 Expenditures for noncharitable purposes.

(a) *In general.* Under section 4945(d)(5) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B). Thus, ordinarily only an expenditure for an activity which, if it were a substantial part of the organization's total activities, would cause loss of tax exemption is a taxable expenditure under section 4945(d)(5). For purposes of this section and §§ 53.4945–1 through 53.4945–5, the term ''purposes described in section 170(c)(2)(B)'' shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by an organization described in section 170(c).

(b) *Particular expenditures.* (1) The following types of expenditures ordinarily will not be treated as taxable expenditures under section 4945(d)(5):

(i) Expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B),

(ii) Reasonable expenses with respect to investments described in subdivision (i) of this subparagraph,

(iii) Payment of taxes,

(iv) Any expenses which qualify as deductions in the computation of unrelated business income tax under section 511,

(v) Any payment which constitutes a qualifying distribution under section 4942(g) or an allowable deduction under section 4940,

(vi) Reasonable expenditures to evaluate, acquire, modify, and dispose of program-related investments, or

(vii) Business expenditures by the recipient of a program-related investment.

(2) Conversely, any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence. The determination whether an expenditure is unreasonable shall depend upon the facts and circumstances of the particular case.

(c) *Grants to ''noncharitable'' organizations*—(1) *In general.* Since a private foundation cannot make an expenditure for a purpose other than a purpose described in section 170(c)(2)(B), a private foundation may not make a grant to an organization other than an organization described in section 501(c)(3) unless

(i) The making of the grant itself constitutes a direct charitable act or the making of a program-related investment, or

(ii) Through compliance with the requirements of subparagraph (2) of this paragraph, the grantor is reasonably assured that the grant will be used exclusively for purposes described in section 170(c)(2)(B).

For purposes of this paragraph, an organization treated as a section 509(a)(1) organization under § 53.4945–5(a)(4) shall be treated as an organization described in section 501(c)(3).

(2) *Grants other than transfers of assets described in § 1.507–3(c)(1).* (i) If a private foundation makes a grant which is not a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization to any organization (other than an organization described in section 501(c)(3) except an organization described in section 509(a)(4)), the grantor is reasonably assured (within the meaning of subparagraph (1)(ii) of this paragraph) that the grant will be used exclusively for purposes described in section 170(c)(2)(B) only if the grantee organization agrees to maintain and, during the period in which any portion of such grant funds remain unexpended, does continuously maintain the grant funds (or other assets transferred) in a separate fund dedicated to one or more purposes described in section 170(c)(2)(B). The grantor of a grant described in this paragraph must also comply with the expenditure responsibility provisions contained in sections 4945(d) and (h) and § 53.4945–5.

(ii) For purposes of this paragraph, a foreign organization which does not

have a ruling or determination letter that it is an organization described in section 501(c)(3) (other than section 509(a)(4)) will be treated as an organization described in section 501(c)(3) (other than section 509(a)(4)) if in the reasonable judgment of a foundation manager of the transferor private foundation, the grantee organization is an organization described in section 501(c)(3) (other than section 509(a)(4)). The term ''reasonable judgment'' shall be given its generally accepted legal sense within the outlines developed by judicial decisions in the law of trusts.

(3) *Transfers of assets described in § 1.507–3(c)(1).* If a private foundation makes a transfer of assets (other than a transfer described in subparagraph (1)(i) of this paragraph) pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization to any person, the transferred assets will not be considered used exclusively for purposes described in section 170(c)(2)(B) unless the assets are transferred to a fund or organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or treated as so described under section 4947(a)(1).

[T.D. 7215, 37 FR 23161, Oct. 31, 1972, as amended by T.D. 7233, 37 FR 28162, Dec. 21, 1972]

Subpart G—Definitions and Special Rules

§ 53.4946–1 Definitions and special rules.

(a) *Disqualified person.* (1) For purposes of Chapter 42 and the regulations thereunder, the following are disqualified persons with respect to a private foundation:

(i) All substantial contributors to the foundation, as defined in section 507 (d)(2) and the regulations thereunder.

(ii) All foundation managers of the foundation as defined in section 4946 (b)(1) and paragraph (f)(1)(i) of this section,

(iii) An owner of more than 20 percent of:

(*a*) The total combined voting power of a corporation,

(*b*) The profits interest of a partnership,

(*c*) The beneficial interest of a trust or unincorporated enterprise.

which is (during such ownership) a substantial contributor to the foundation, as defined in section 507(d)(2) and the regulations thereunder,

(iv) A member of the family, as defined in section 4946(d) and paragraph (h) of this section, of any of the individuals described in subdivision (i), (ii), or (iii) of this subparagraph,

(v) A corporation of which more than 35 percent of the total combined voting power is owned by persons described in subdivision (i), (ii), (iii), or (iv) of this subparagraph,

(vi) A partnership of which more than 35 percent of the profits interest is owned by persons described in subdivision (i), (ii), (iii), or (iv) of this subparagraph, and

(vii) A trust, estate, or unincorporated enterprise of which more than 35 percent of the beneficial interest is owned by persons described in subdivision (i), (ii), (iii), or (iv) of this subparagraph.

(2) For purposes of subparagraphs (1)(iii) (*b*) and (vi) of this paragraph, the profits interest of a partner shall be equal to his distributive share of income of the partnership, as determined under section 707(b)(3) and the regulations thereunder as modified by section 4946(a)(4).

(3) For purposes of subparagraph (1)(iii)(*c*) and (vii) of this paragraph, the beneficial interest in an unincorporated enterprise (other than a trust or estate) includes any right to receive a portion of distributions from profits of such enterprise, and, if the portion of distributions is not fixed by an agreement among the participants, any right to receive a portion of the assets (if any) upon liquidation of the enterprise, except as a creditor or employee. For purposes of this subparagraph, a right to receive distributions of profits includes a right to receive any amount from such profits other than as a creditor or employee, whether as a sum certain or as a portion of profits realized by the enterprise. Where there is no agreement fixing the rights of the participants in such enterprise, the fraction of the respective interests of each participant in such enterprise shall be determined by dividing the amount of

all investments or contributions to the capital of the enterprise made or obligated to be made by such participant by the amount of all investments or contributions to capital made or obligated to be made by all of them.

(4) For purposes of subparagraph (1)(iii) (*c*) and (vii) of this paragraph, a person's beneficial interest in a trust shall be determined in proportion to the actuarial interest of such person in the trust.

(5) For purposes of subparagraph (1)(iii) (*a*) and (v) of this paragraph, the term ''combined voting power'' includes voting power represented by holdings of voting stock, actual or constructive (under section 4946(a)(3)), but does not include voting rights held only as a director or trustee.

(6) For purposes of subparagraph (1)(iii) (*a*) and (v) of this paragraph, the term ''voting power'' includes outstanding voting power and does not include voting power obtainable but not obtained, such as, for example, voting power obtainable by converting securities or nonvoting stock into voting stock or by exercising warrants or options to obtain voting stock, and voting power which will vest in preferred stockholders only if and when the corporation has failed to pay preferred dividends for a specified period of time or has otherwise failed to meet specified requirements. Similarly, for purposes of subparagraph (1)(iii) (*b*) and (*c*), (vi), and (vii) of this paragraph, the terms ''profits interest'' and ''beneficial interest'' include any such interest that is outstanding, but do not include any such interest that is obtainable but has not been obtained.

(7) For purposes of sections 170(b)(1)(E)(iii), 507(d)(1), 508(d), 509(a) (1) and (3), and Chapter 42, the term ''disqualified person'' shall not include an organization which is described in section 509(a) (1), (2), or (3), or any other organization which is wholly owned by such section 509(a) (1), (2), or (3) organization.

(8) For purposes of section 4941 only, the term ''disqualified person'' shall not include any organization which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

(b) *Section 4943.* (1) For purposes of section 4943 only, the term ''disqualified person'' includes a private foundation:

(i) Which is effectively controlled (within the meaning of § 1.482–1(a)(3) of this chapter), directly or indirectly, by the same person or persons (other than a bank, trust company, or similar organization acting only as a foundation manager) who control the private foundation in question, or

(ii) Substantially all the contributions to which were made, directly or indirectly, by persons described in subdivision (i), (ii), (iii), or (iv) of paragraph (a)(1) of this section who made, directly or indirectly, substantially all of the contributions to the private foundation in question.

(2) For purposes of subparagraph (1)(ii) of this paragraph, one or more persons will be considered to have made substantially all of the contributions to a private foundation, if such persons have contributed or bequeathed at least 85 percent (and each such person has contributed or bequeathed at least 2 percent) of the total contributions and bequests (within the meaning of section 507(d)(2) and the regulations thereunder) which have been received by such private foundation during its entire existence.

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

Example 1. A, a private foundation, has a board of directors made up of X, Y, Z, M, N, and O. Foundation B's board of directors is made up of Y, M, N, and O. The board of directors in each case has plenary power to determine the manner in which the foundation is operated. For purposes of section 4943, foundation A is a disqualified person with respect to foundation B, and foundation B, is a disqualified person with respect to foundation A.

Example 2. Private foundation A has received contributions of $100,000 throughout its existence: $35,000 from X, $51,000 from Y (who is X's father), and $14,000 from Z (an unrelated person). Private foundation B has received $100,000 in contributions during its existence: $50,000 from X and $50,000 from W, X's wife.

For purposes of section 4943, private foundation A is a disqualified person with respect to private foundation B, and private foundation B is a disqualified person with respect to private foundation A.

(c) *Section 4941.* For purposes of section 4941, a government official, as defined in section 4946(c) and paragraph (g) of this section, is a disqualified person.

(d) *Attribution of stockholdings.* (1) For purposes of paragraph (a)(1)(iii) (*a*) and (v) of this section, indirect stockholdings shall be taken into account under section 267(c) and the regulations thereunder. However, for purposes of this paragraph:

(i) Section 267(c)(4) shall be treated as though it provided that the members of the family of an individual are the members within the meaning of section 4946(d) and paragraph (h) of this section; and

(ii) Any stockholdings which have been counted once (whether by reason of actual or constructive ownership) in applying section 4946(a)(1)(E) shall not be counted a second time.

For purposes of paragraph (a)(1)(v) or this section, section 267(c) shall be applied without regard to section 267(c)(3), and stock constructively owned by an individual by reason of the application of section 267(c)(2) shall not be treated as owned by him if he is described in section 4946(a)(1)(D) but not also in section 4946(a)(1) (A), (B), or (C).

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

Example 1. D is a substantial contributor to private foundation Y. D owns 20 percent of the outstanding stock of corporation P. E, D's wife, owns none of the outstanding stock of P. F, E's father, owns 10 percent of the outstanding stock of P. E is treated under section 507(d)(2) as a substantial contributor to Y. E is also treated under section 267(c)(2) as owning both D's 20 percent and F's 10 percent of P, but E is treated as owning nothing for purposes of section 4946(a)(1)(E) because D's 20 percent and F's 10 percent have already been taken into account once (because of their actual ownership of the stock of P) for such purposes. Hence, corporation P is not a disqualified person under section 4946(a)(1)(E) with respect to private foundation Y because persons described in section 4946(a)(1) (A), (B), (C), and (D) own only 30 percent of the stock of P.

Example 2. I, a substantial contributor to private foundation X, is the son of J. I owns 100 percent of the stock of corporation R, which in turn owns 18 percent of the stock of corporation S. J owns 18 percent of the stock of S. I constructively owns 36 percent of the stock of S (J's 18 percent plus R's 18 percent). Both J's actual holdings and R's actual holdings are counted in determining I's constructive holdings because this does not result in counting either of the holdings more than once for purposes of section 4946 (a)(1)(E). Therefore, S is a disqualified person with respect to private foundation X, since I, a substantial contributor, constructively owns more than 35 percent of S's stock.

(e) *Attribution of profits or beneficial interests.* (1) For purposes of paragraph (a) (1) (iii) (*b*), (iii) (*c*) (vi), and (vii) of this section, ownership of profits or beneficial interests shall be taken into account as though such ownership related to stockholdings, if such stockholdings would be taken into account under section 267(c) and the regulations thereunder, except that section 267(c)(3) shall not apply to attribute the ownership of one partner to another solely by reason of such partner relationship. However, for purposes of this paragraph:

(i) Section 267(c)(4) shall be treated as though it provided that the members of the family of an individual are the members within the meaning of section 4946(d) and paragraph (h) of this section; and

(ii) Any profits interest or beneficial interest which has been counted once (whether by reason of actual or constructive ownership) in applying section 4946(a)(1) (F) or (G) shall not be counted a second time.

For purposes of paragraph (a)(1) (vi) and (vii) of this section, profits or beneficial interests constructively owned by an individual by reason of the application of section 267(c)(2) shall not be treated as owned by him if he is described in section 4946(a)(1)(D) but not in section 4946(a)(1)(A), (B) or (C).

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Partnership S is a substantial contributor to private foundation X. Trust T, of which G is sole beneficiary, owns 12 percent of the profits interest of S. G's husband, H, owns 10 percent of the profits interest of S. H is a disqualified person with respect to X (under section 4946(a)(1)(C)) because he is considered to own 22 percent of the profits interest of S (10 percent actual ownership, plus G's 12 percent constructively under section 267(c)(2)). G is a disqualified person with

respect to X (under section 4946(a)(1)(C) because she is considered to own 22 percent of the profits interest of S (12 percent constructively by reason of her beneficial interest in trust T, plus 10 percent constructively under section 267(c)(2) by reason of being a member of the family of H).

(f) *Foundation manager*. (1) For purposes of Chapter 42 and the regulations thereunder, the term ''foundation manager'' means:

(i) An officer, director, or trustee of a foundation (or a person having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and

(ii) With respect to any act or failure to act, any employee of the foundation having final authority or responsibility (either officially or effectively) with respect to such act or failure to act.

(2) For purposes of subparagraph (1)(i) of this paragraph, a person shall be considered an officer of a foundation if:

(i) He is specifically so designated under the certificate of incorporation, bylaws, or other constitutive documents of the foundation; or

(ii) He regularly exercises general authority to make administrative or policy decisions on behalf of the foundation.

With respect to any act or failure to act, any person described in subdivision (ii) of this subparagraph who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer. Moreover, such independent contractors as attorneys, accountants, and investment managers and advisers, acting in their capacities as such, are not officers within the meaning of subparagraph (1)(i) of this paragraph.

(3) For purposes of subparagraph (1)(ii) of this paragraph, an individual rendering services to a private foundation shall be considered an employee of the foundation only if he is an employee within the meaning of section 3121(d)(2).

(4) Since the definition of the term ''disqualified person'' contained in section 4946(a)(1)(B) incorporates only so much of the definition of the term ''foundation manager'' as is found in section 4946(b)(1) and subparagraph (1)(i) of this paragraph, any references, in section 4946 and this section, to ''disqualified persons'' do not constitute references to persons who are ''foundation managers'' solely by reason of the definition of that term contained in section 4946(b)(2) and subparagraph (1)(ii) of this paragraph.

(g) *Government official*—(1) *In general*. Except as provided in subparagraph (3) of this paragraph, for purposes of section 4941 and paragraph (c) of this section, the term ''government official'' means, with respect to an act of selfdealing described in section 4941, an individual who, at the time of such act, is described in subdivision (i), (ii), (iii), (iv), or (v) of this subparagraph (other than a ''special Government employee'' as defined in 18 U.S.C. 202(a)):

(i)(*a*) An individual who holds an elective public office in the executive or legislative branch of the Government of the United States.

(*b*) An individual who holds an office in the executive or judicial branch of the Government of the United States, appointment to which was made by the President.

(ii) An individual who holds a position in the executive, legislative or judicial branch of the Government of the United States:

(*a*) Which is listed in schedule C of rule VI of the Civil Service Rules, or

(*b*) The compensation for which is equal to or greater than the lowest rate prescribed for GS–16 of the General Schedule under 5 U.S.C. 5332.

(iii) An individual who holds a position under the House of Representatives or the Senate of the United States, as an employee of either of such bodies, who receives gross compensation therefrom at an annual rate of $15,000 or more.

(iv) The holder of an elective or appointive public office in the executive, legislative, or judicial branch of the government of a State, possession of the United States, or political subdivision or other area of any of the foregoing, or of the District of Columbia, for which the gross compensation is at an annual rate of $15,000 or more, who is described in subparagraph (2) of this paragraph.

(v) The holder of a position as personal or executive assistant or secretary to any individual described in subdivision (i), (ii), (iii), or (iv) of this subparagraph.

(2) *Public office*—(i) *Definition*. In defining the term ''public office'' for purposes of section 4946(c)(5) and subparagraph (1)(iv) of this paragraph, such term must be distinguished from mere public employment. Although holding a public office is one form of public employment, not every position in the employ of a State or other governmental subdivision (as described in section 4946 (c)(5)) constitutes a ''public office''. Although a determination whether a public employee holds a public office depends on the facts and circumstances of the case, the essential element is whether a significant part of the activities of a public employee is the independent performance of policymaking functions. In applying this subparagraph, several factors may be considered as indications that a position in the executive, legislative, or judicial branch of the government of a State, possession of the United States, or political subdivision or other area of any of the foregoing, or of the District of Columbia, constitutes a ''public office''. Among such factors to be considered in addition to that set forth above, are that the office is created by the Congress, a State constitution, or the State legislature, or by a municipality or other governmental body pursuant to authority conferred by the Congress, State constitution, or State legislature, and the powers conferred on the office and the duties to be discharged by such office are defined either directly or indirectly by the Congress, State constitution, or State legislature, or through legislative authority.

(ii) *Illustrations*. The following are illustrations of positions of public employment which do not involve policymaking functions within the meaning of subdivision (i) of this subparagraph and which are thus not a ''public office'' for purposes of section 4946(c)(5) and subparagraph (1)(iv) of this paragraph:

(*a*) The chancellor, president, provost, dean, and other officers of a State university who are appointed, elected, or otherwise hired by a State Board of Regents or equivalent public body and who are subject to the direction and supervision of such body;

(*b*) Professors, instructors, and other members of the faculty of a State educational institution who are appointed, elected, or otherwise hired by the officers of the institution or by the State Board of Regents or equivalent public body;

(*c*) The superintendent of public schools and other public school officials who are appointed, elected, or otherwise hired by a Board of Education or equivalent public body and who are subject to the direction and supervision of such body;

(*d*) Public school teachers who are appointed, elected, or otherwise hired by the superintendent of public schools or by a Board of Education or equivalent public body;

(*e*) Physicians, nurses, and other professional persons associated with public hospitals and State boards of health who are appointed, elected, or otherwise hired by the governing board or officers of such hospitals or agencies; and

(*f*) Members of police and fire departments, except for those department heads who, under the facts and circumstances of the case, independently perform policymaking functions as a significant part of their activities.

(3) *Certain government officials on leave of absence*. For purposes of this paragraph, an individual who is otherwise described in section 4946(c) and this paragraph who was on leave of absence without pay on December 31, 1969, from his position or office pursuant to a commitment entered into on or before such date to engage in certain activities for which he is paid by one or more private foundations, is not to be treated as holding such position or office for any continuous period after December 31, 1969, and prior to January 1, 1971, during which such individual remains on leave of absence to engage in the same activities for which he is paid by such foundations. For purposes of this subparagraph, a commitment is considered entered into on or before December 31, 1969, if on or before such date, the amount and nature of the payments to be made and the name of the

individual receiving such payments were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee orally or in writing.

(h) *Members of the family*. For purposes of this section, the members of the family of an individual include only:

(1) His spouse,

(2) His ancestors,

(3) His lineal descendants, and

(4) Spouses of his lineal descendants.

For example, a brother or sister of an individual is not a member of his family for purposes of this section. However, for example, the wife of a grandchild of an individual is a member of his family for such purposes. For purposes of this paragraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

[T.D. 7241, 37 FR 28744, Dec. 29, 1972]

Subpart H—Application to Certain Nonexempt Trusts

§ 53.4947–1 Application of tax.

(a) *In general*. Section 4947 subjects trusts which are not exempt from taxation under section 501(a), all or part of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 to the same requirements and restrictions as are imposed on private foundations. The basic purpose of section 4947 is to prevent these trusts from being used to avoid the requirements and restrictions applicable to private foundations. For purposes of this section, a trust shall be presumed (in the absence of proof to the contrary) to have amounts under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if a deduction would have been allowable under one of these sections. Also for purposes of this section and § 53.4947–2, the term ''purposes described in section 170(c)(2)(B)'' shall be treated as including purposes described in section 170(c)(1).

(b) *Charitable trusts*—(1) *General rule*. (i) For purposes of this section and § 53.4947–2, a *charitable trust*, within the meaning of section 4947(a)(1), is a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law). A trust is one for which a deduction was allowed under section 642(c), within the meaning of section 4947(a)(1), once a deduction is allowed under section 642(c) to the trust for any amount paid or permanently set aside. (See sections 642(c) and § 1.642–4 for the limitation on such deduction in certain cases.) A charitable trust (as defined in this paragraph) shall be treated as an organization described in section 501(c)(3) and, if it is determined under section 509 that the trust is a private foundation, then Part II of Subchapter F of chapter 1 of the Code (other than section 508 (a), (b) and (c) and Chapter 42 shall apply to the trust. However, the charitable trust is not treated as an organization described in section 501(c)(3) for purposes of exemption from taxation under section 501(a). Thus, the trust is subject to the excise tax on its investment income under section 4940(b) rather than the tax imposed by section 4940(a). For purposes of satisfying the organizational test described in § 1.501 (c)(3)–1(b) when a charitable trust seeks an exemption from taxation under section 501(a), a charitable trust (as defined in this paragraph) shall be considered organized on the day it first becomes subject to section 4947(a)(1). However, for purposes of the special and transistional rules in section 4940(c)(4)(B), 4942(f)(4), 4943(c)(4)(A)(i) and (B) and section 101(1)(2)(A), (B), (C), and (D), and (1)(3) of the Tax Reform Act of 1969, a charitable trust (as defined in this paragraph) shall be considered organized on the first day it has amounts in trust for which a deduction was allowed (within the meaning of paragraph (a) of this section) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. Thus, under this

rule, a trust may be treated as a private foundation in existence on a date governing one of the applicable special and transistional rules even though the trust did not otherwise become subject to the provisions of Chapter 42 until a later date.

(ii) The provisions of paragraph (b)(1) of this section may be illustrated by the following examples:

Example 1. On January 30, 1970, X creates an inter vivos trust under which M receives 50 percent and N receives 50 percent of the trust's income for 10 years, and upon the termination of which, at the end of the 10-year period, the corpus is to be distributed to O. M, N and O are all organizations described in section 501(c)(3) and X is allowed a deduction under section 170 for the value of all interests placed in trust. The trustees of the trust do not give notice to the Internal Revenue Service under the provisions of section 508(a), and the trust will therefore not be exempt from taxation under section 501(a). The trust is a charitable trust within the meaning of section 4947(a)(1) from the date of its creation.

Example 2. On March 1, 1971, Y creates a charitable remainder annuity trust described in section 664(d)(1) under which Z, Y's son, receives $10,000 per year for life, remainder to be held in trust for P, an organization described in section 501(c)(3). Y is allowed a deduction under section 170 for the present value of the remainder interest to P. During Z's lifetime, the trust is a split-interest trust described in section 4947(a)(2) and paragraph (c) of this section. Upon the death of Z, all unexpected interests (consisting of P's remainder interest) will be devoted to section 170(c)(2)(B) purposes. Except as provided in § 53.4947–1(b)(2)(iv) (relating to a reasonable period of settlement) the trust will be treated as a charitable trust within the meaning of section 4947(a)(1) from the date of the death of Z unless the trustees of the trust apply for recognition of section 501(c)(3) status under the provisions of section 508(a).

(2) *Scope of application of section 4947(a)(1)*—(i) *In general.* Subject to paragraph (b)(2) (ii) through (vii) of this section, section 4947(a)(1) applies to nonexempt trusts in which all unexpired interests are charitable. For purposes of this section, the term *charitable* when used to describe an interest or beneficiary refers to the purposes described in section 170(c)(2)(B). An estate from which the executor or administrator is required to distribute all of the net assets in trust to such beneficiaries will not be considered a charitable trust under section 4947(a)(1) during the period of estate administration or settlement, except as provided in paragraph (b)(2)(ii) of this section. A charitable trust created by will shall be considered a charitable trust under section 4947(a)(1) as of the date of death of the decedent-grantor, except as provided in paragraph (b)(2)(v) of this section (relating to trusts which wind up. For the circumstances under which segregated amounts are treated as charitable trusts, see § 53.4947–1(c)(3)(iii).

(ii) *Estates.* (A) When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under § 1.641(b)–3(a), then the estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under § 1.641(b)–3(a) and the date final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries. This (ii) does not affect the determination of the tax liability under Subtitle A of the beneficiaries of the estates.

(B) The provisions of this (ii) may be illustrated by the following example:

Example. X bequeaths his entire estate, including 100 percent of the stock of a wholly-owned corporation, to M, an organization described in section 501(c)(3), under a will which gives his executor authority to hold the stock and manage the corporation for a period of up to 10 years for the benefit of M prior to its ultimate disposition. A deduction for the charitable bequest was allowed to X's estate under section 2055. The executor is vested with a full range of powers, including the power of sale. Upon the death of X, his executor distributes X's assets to M except for the stock of the corporation, which he holds for 5 years prior to its disposition. The continued holding of the stock of the corporation by the executor after the expiration of a reasonable time for performance of all the ordinary duties of administration causes the estate to be considered terminated for Federal income tax purposes pursuant to § 1.641(b)–3(a) and thereby subjects it to the provisions of section 4947(a)(1) from the date of such termination to the date of final disposition of the stock of the corporation.

(iii) *Certain split-interest trusts which wind up.* A split-interest trust (as defined in paragraph (c) of this section) in which all of the unexpired interests are charitable remainder interests and in which the charitable beneficiaries have become entitled to distributions of corpus in trust or free of trust shall continue to be treated as as split-interest trust under section 4947(a)(2) until the date on which final distribution of all the net assets is made. However, if after the expiration of any intervening interests the trust is considered terminated for Federal income tax purposes under § 1.641(b)–3(b), then the trust will be treated as a charitable trust under section 4947(a)(1), rather than a split interest trust under section 4947(a)(2), between the date on which the trust is considered terminated under § 1.641(b)–3(b) and the date on which such final distribution of all of the net assets is made to or for the benefit of the charitable remainder beneficiaries. This (iii) does not affect the determination of the tax liability under subtitle A of the beneficiaries of the trusts.

(iv) *Split-interest trusts which become charitable trusts.* (A) A split-interest trust (as defined in paragraph (c) of this section) in which all of the unexpired interests are charitable remainder interests and in which some or all of the charitable beneficiaries are not entitled to distributions of corpus within the meaning of paragraph (b)(2)(iii) of this section shall continue to be treated as a split-interest trust under section 4947(a)(2) rather than a charitable trust under section 4947(a)(1) for a reasonable period of settlement after the expiration of the noncharitable interest. Thus, a split-interest trust which under its terms is to continue to hold assets for charitable beneficiaries after the expiration of the noncharitable interest rather than distributing them as in paragraph (b)(2)(iii) of this section is given a reasonable period of settlement before being treated as a charitable trust. For purposes of this paragraph, the term *reasonable period of settlement* means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries.

(B) This (iv) may be illustrated by the following example:

Example. On January 15, 1971, A creates a charitable remainder annuity trust described in section 661(d)(1) under which the trustees are required to distribute $10,000 a year to B, A's wife, for life, remainder to be held in trust for the use of M, an organization described in section 501(c)(3). A is allowed a deduction under section 170 for the amount of the charitable interest, and the trust is, therefore, treated as a split-interest trust under section 4947(a)(2) from the date of its creation. B dies on February 10, 1975. On April 15, 1975, the trustees complete performance of the ordinary duties of administration necessary for the settlement of the trust brought about by the death of B. These duties include, for example, an accounting for and payment to the estate of B of amounts accrued by B while alive during 1975. However, the trustees do not distribute the corpus to M by April 15, 1975. The trust shall continue to be treated as a split-interest trust under section 4947(a)(2) until April 15, 1975. After April 15, 1975, the trust shall be treated as a charitable trust under section 4947(a)(1).

(v) *Certain revocable and testamentary trusts which wind up.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust for or free of trust to charitable beneficiaries is not considered a charitable trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable. After that period the trust is considered a charitable trust under section 4947(a)(1).

(vi) *Revocable trusts which become charitable trusts.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor in which all of the unexpired interests are charitable and under the terms of the governing instrument of which the trustee is required to hold some or all of the net assets in trust after becoming irrevocable solely for charitable beneficiaries is not considered a trust under section

4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable except that section 4941 may apply if the requirements of § 53.4941(d)–1 (b)(3) are not met. After that period, the trust is considered a charitable trust under section 4947(a)(1).

(vii) *Trust devoted to 170(c) purposes.* (A) A trust all of the unexpired interests in which are devoted to section 170 (c) (3) or (5) purposes together with section 170(c)(2)(B) purposes shall be considered a charitable trust except that payments under the terms of the governing instrument to an organization described in section 170(c) (3) or (5) shall not be considered a violation of section 4945(d)(5) or any other provisions of Chapter 42 and shall be considered qualifying distributions under section 4942.

(B) *Example.* The application of paragraph (b)(2)(vii) of this section may be illustrated by the following example:

Example. On January 30, 1970, H creates an inter vivos trust under the terms of the governing instruments of which M, an organization described in section 170(c)(3), and N, an organization described in section 501(c)(3), are each to receive 50 percent of the income for a period of 10 years. At the end of the 10 year period, the corpus is to be distributed to O, an organization also described in section 501(c)(3). H is allowed a deduction under section 170 for the value of all interests placed in trust. The payments to M do not constitute a violation of section 4945(d)(5) or any other provision of Chapter 42 and constitute qualifying distributions under section 4942. However, except as provided in the previous sentence, the trust shall be considered a charitable trust.

(3) *Charitable trusts described in section 509(a)(3).* For purposes of section 509(a)(3)(A), a charitable trust shall be treated as if organized on the day on which it first becomes subject to section 4947(a)(1). However, for purposes of applying §§ 1.509(a)–4(d) (2)(iv)(*a*), and 1.509(a)–4(i)(1) (ii) and (iii)(*c*) the previous relationship between the charitable trust and the section 509(a) (1) or (2) organizations it benefits or supports may be considered. If the charitable trust otherwise meets the requirements of section 509(a)(3), it may obtain recognition of its status as a section 509(a)(3) organization by requesting a ruling from the Internal Revenue Service. For the special rules pertaining to the application of the organizational test to organizations terminating their private foundation status under the 12-month or 60-month termination period provided under section 507(b)(1)(B) by becoming ''public'' under section 509(a)(3), see the regulations under section 507(b)(1).

(c) *Split-interest trusts*—(1) *General rule*—(i) *Definition.* For purposes of this section and § 53.4947–2, a *split-interest trust,* within the meaning of section 4947(a)(2), is a trust which is not exempt from taxation under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed (within the meaning of paragraph (a) of this section) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. A trust is one which has amounts in trust for which a deduction was allowed under section 642(c) within the meaning of section 4947(a)(2) once a deduction is allowed under section 642(c) to the trust for any amount permanently set aside. This (i) also includes any trust which is not treated as a charitable trust by operation of paragraph (b)(2) (iii) or (iv) of this section (relating to split-interest trusts in the process of winding up or during a reasonable period of settlement). Section 4947(a)(1) shall apply to a trust described in this (i) (without regard to section 4947(a)(2)(A), (B), or (C)) from the first date upon which the provisions of paragraph (b)(2) (iii) or (iv) of this section are satisfied. For the circumstances under which a trust all of the unexpired interests in which are devoted to section 170(c) (3) or (5) purposes together with section 170(c)(2)(B) purposes is considered a charitable trust, see § 53.4947–1(b)(2)(vii).

(ii) *Applicability of statutory rules.* A split-interest trust is subject to the provisions of section 507 (except as provided in paragraph (e) of this section), 508(e) (to the extent applicable to a split-interest trust), 4941, 4943 (except as provided in section 4947(b)(3)), 4944 (except as provided in section 4947(b)(3)), and 4945 in the same manner

as if such trust were a private foundation.

(iii) *Special rules.* A newly created trust shall, for purposes of section 4947(a)(2), be treated as having amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 from the date of its creation, even if a deduction was allowed for such amounts only at a later date. For purposes of this (iii), the date of creation of a charitable remainder trust shall be determined by applying the rules in § 1.664–1(a)(4).

(2) *Exception for amounts payable to income beneficiaries.* (i) Under section 4947(a)(2)(A), paragraph (c)(1)(ii) of this section does not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2) (B), or 2522(c)(2)(B) with respect to the income interest of any such beneficiary. See § 1.170A–6(c), § 20.2055(e)(2), and § 25.2522(c)–3(c)(2) for rules regarding the allowance of these deductions. However, section 4947(a)(2)(A) does not apply when the value of all interests in property transferred in trust are deductible under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. H creates a charitable remainder unitrust (described in section 664(d)(2)) which is required annually to pay W, H's wife, 5 percent of the net fair market value of the trust assets, valued annually, for her life; and to pay the remainder to Y, a section 501(c)(3) organization. A deduction under section 170(f)(2)(A) was allowed with respect to the remainder interest of Y. Under section 4947(a)(2)(A), each annual amount which becomes payable to W during her life is not subject to paragraph (c)(1)(ii) of this section on or after the date upon which it becomes so payable and the payment of each amount to W is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust.

Example 2. H bequeaths the residue of his estate in trust for the benefit of S, his son, and Y, an organization described in section 501(c)(3). A guaranteed annuity interest of $10,000 is to be paid to S for 20 years. A guaranteed annuity interest of $5,000 which meets the requirements contained in § 20.2055–2(e)(2)(v)(*a*) is also to be paid to Y for 20 years. Upon termination of the 20-year term, the corpus is to be distributed to Z, another organization described in section 501(c)(3). The trust is a charitable remainder annuity trust as described in section 664(d)(1) and the regulations thereunder, and a deduction under section 2055(e)(2)(A) was allowed with respect to the remainder interest of Z. A deduction was also allowed under section 2055(e)(2)(B) with respect to the guaranteed annuity interest of Y. The assets in the trust are not segregated under section 4947(a)(2)(B) and paragraph (c)(3) of this section. Under section 4947(a)(2)(A), each payment of $10,000 to S is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section. The payment of each amount to S is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust.

Example 3. H creates a trust under which the trustees are required to pay over an annuity interest of $20,000 to W. H's wife, for her life. A guaranteed annuity interest of $10,000 which meets the requirements contained in § 25.2522(c)–3(c)(2)(v) is also to be paid X, an organization described in section 501(c)(3), for the life of W. Upon the death of W, the corpus of the trust, which consists of office buildings M and N, is to be distributed to S. H's son. H received a deduction under section 2522(c)(2)(B) for the value of X's income interest in the trust. The assets in the trust are not segregated under section 4947(a)(2)(B) and paragraph (c)(3) of this section. Under section 4947(a)(2)(A), each payment of $20,000 to W is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section. The payment of each amount to W is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust. See example (1) of paragraph (c)(3)(v) of this section for the application of section 4947(a)(2)(B) to a similar trust where the trustees segregate the assets of the trust.

(3) *Exception for certain segregated amount*—(i) *In general.* Under section 4947(a)(2)(B) paragraph (c)(1)(ii) of this section does not apply to assets held in trust (together with the income and capital gains derived from the assets), which are segregated from other assets held in trust for which a deduction was

allowed for an income or remainder interest under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

(ii) *Segregation of amounts.* Amounts will generally be considered segregated (within the meaning of section 4947(a)(2)(B) if:

(A) Assets with respect to which no deduction was allowed (for an income or remainder interest) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, are separately accounted for under section 4947(a)(3) and paragraph (c)(4) of this section from assets for which such a deduction was allowed for any income or remainder interest and,

(B) By reason of the separate accounting the trust can be treated as two separate trusts, one of which is devoted exclusively to noncharitable income and remainder interests and the other of which is a charitable trust described in section 4947(a)(1) or a split-interest trust described in section 4947(a)(2).

Under these circumstances, only the ''trust'' which is devoted exclusively to noncharitable income and remainder interests will be considered a segregated amount which under section 4947(a)(2)(B), is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

(iii) *Exclusively charitable amounts.* If, under section 4947(a)(2)(B),

(A) An amount held in trust which is devoted exclusively to noncharitable income and remainder interests is segregated from

(B) An amount held in trust which is devoted exclusively to charitable income and remainder interests,

Then for purposes of this section the amount described in paragraph (c)(3)(iii)(B) of this section will be treated as a charitable trust which is subject to the provisions of section 4947(a)(1).

(iv) *Charitable and noncharitable amounts.* If, under section 4947(a) (2)(B),

(A) An amount held in trust which is devoted exclusively to noncharitable income and remainder interests is segregated from

(B) An amount held in trust which is devoted to both charitable income or remainder interests and noncharitable income or remainder interests,

Then for purposes of this section the amount described in paragraph (c)(3)(iv)(B) of this section will be treated as a split-interest trust which is subject to the provisions of section 4947(a)(2).

(v) *Examples.* The application of paragraph (c)(3) of this section may be illustrated by the following examples:

Example 1. H creates a trust under which the trustees are required to pay over annually 5 percent of the net fair market value of M building, valued annually, to W, H's wife, for life, remainder to S, H's son. The other asset in the trust is N building, with respect to which the trustees are required to pay over annually 5 percent of the net fair market value of the building, valued annually, to X, a section 501(c)(3) organization, for a period of 15 years, remainder to S. Each asset is separately accounted for under section 4947(a)(3) and paragraph (c)(4) of this section. He received a deduction under section 2522 for the value of X's income interest in N building. Under these circumstances, M building is considered segregated (within the meaning of section 4947(a)(2)(B)) from N building and is not subject to section 4947 (a)(2). The remainder interest of S in N building is not considered segregated from the income interest of X in N building, since both are interests in the same asset. N building is considered held in a split-interest trust which is subject to section 4947 (a)(2) and paragraph (c)(1)(ii) of this section.

Example 2. H transfers $50,000 in trust to pay $2,500 per year to Z, a section 501(c)(3) organization, for a term of 20 years, remainder to S. H's son. H is allowed a deduction under section 2522 for the present value of Z's income interest. The income interest of Z in the trust asset cannot be segregated (within the meaning of section 4947(a)(2)(B)) from the remainder interest of S since both are interests in the same asset. Therefore, the entire trust is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

(4) *Accounting for segregated amounts*—(i) *General rule.* Under section 4947(a)(2)(B), a trust with respect to which amounts are segregated within the meaning of paragraph (c)(3) of this section must separately account for the various income, deduction, and other items properly attributable to each segregated amount in the books of account and separately account to each of the beneficiaries of the trust.

(ii) *Method.* Separate accounting shall be made:

(A) According to the method regularly employed by the trust, if the method is reasonable, and

(B) In all other cases in a manner which, in the opinion of the Commissioner, is reasonable.

A method of separate accounting will be considered ''regularly employed'' by a trust when the method has been consistently followed in prior taxable years or when a trust which has never before maintained segregated amounts initiates a reasonable method of separate accounting for its segregated amounts and consistently follows such method thereafter. The trust shall keep permanent records and other data relating to the segregated amounts as are necessary to enable the district director to determine the correctness of the application of the rules prescribed in paragraph (c) (3) and (4) of this section.

(5) *Amounts transferred in trust before May 27, 1969*—(i) *General rule.* Under section 4947(a)(2)(C), paragraph (c)(1)(ii) of this section does not apply to any amounts transferred in trust before May 27, 1969. For purposes of this (5), an amount shall be considered to be transferred in trust only when the transfer is one which meets the requirements for the allowance of a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law). Income and capital gains which are derived at any time from amounts transferred in trust before May 27, 1969, shall also be excluded from the application of paragraph (c)(1)(ii) of this section. If an asset which was transferred in trust before May 27, 1969, is sold or exchanged after May 26, 1969, any asset received by the trust upon the sale or exchange shall be treated as an asset which was transferred in trust before May 27, 1969.

(ii) *Requirement for separate accounting for amounts transferred in trust before May 27, 1969.* If:

(A) Amounts are transferred in trust after May 26, 1969, and the trust to which the amounts are transferred also contains

(B) Amounts transferred in trust before May 27, 1969,

the general rule of paragraph (c)(5)(i) of this section applicable to the amounts described in paragraph (c)(5)(ii)(B) of this section will apply only if the amounts described in paragraph (c)(5)(ii)(A) of this section (together with all income and capital gains derived therefrom) are separately accounted for (within the meaning of paragraph (c)(4) of this section) from the amounts described in paragraph (c)(5)(ii)(B) of this section, together with all income and capital gains derived therefrom. For the application of section 508(e) to a trust with respect to which amounts were transferred both before and after May 27, 1969, see section 508(e) and the regulations thereunder.

(iii) *Exception for certain testamentary trusts.* (A) Amounts transferred in trust before May 27, 1969 include amounts transferred in trust after May 26, 1969 when the transfer is made under the terms of a testamentary trust created by the will of a decedent who died before May 27, 1969, (regardless of whether the executors or the testamentary trustees are required to execute testamentary trusts by court order under applicable local law). Amounts transferred in trust before May 27, 1969, also include amounts transferred to a testamentary trust created by the will of a decedent who died after May 26, 1969 if the will was executed before May 27, 1969 and no dispositive provision of the will was amended (within the meaning of § 20.2055–2(e)(4) and (5)) by the decedent by codicil or otherwise, after May 26, 1969, and the decedent was on May 27, 1969, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to amend the will by codicil or otherwise.

(B) The provisions of this (iii) may be illustrated by the following example:

Example. X executed a will in 1960 which provided for the creation of a testamentary trust which meets the description of a split-interest trust under section 4947(a)(2). X died on April 15, 1969. Under the provisions of his will, the probate court permitted certain property in X's estate to be transferred to the testamentary trust at fixed intervals over a period of two years during the administration of the estate. Section 4947(a)(2) does not apply to any amount described in this example, including the amounts transferred after May 26, 1969, because, for purposes of section 4947(a)(2)(C), each such transfer will be treated as an amount transferred in trust

before May 27, 1969, within the meaning of section 4947(a)(2)(C).

(6) *Scope of application of section 4947(a)(2)*—(i) *In general.* Subject to paragraph (c)(6) (ii), (iii), and (iv) of this section, section 4947(a)(2) applies to trusts in which some but not all unexpired interests are charitable. An estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries will not be considered to be a split-interest trust under section 4947(a)(2) during the period of estate administration or settlement, except as provided in paragraph (c)(6)(ii) of this section. A split-interest trust created by will shall be considered a split-interest trust under section 4947(a)(2) as of the date of death of the decedent-grantor, except as provided in paragraph (c)(6)(iv) of this section.

(ii) *Estates.* (A) When an estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is considered terminated for Federal income tax purposes under § 1.641(b)–3(a), then the estate will be treated as a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4957(a)(1), if applicable) between the date on which the estate is considered terminated under § 1.641(b)–3(a) and the date on which final distribution of the net assets to the last remaining charitable beneficiary is made. This (ii) does not affect the determination of the tax liability under subtitle A of either charitable or noncharitable beneficiaries of the estates.

(B) The provisions of this (ii) may be illustrated by the following example:

Example. X dies on January 15, 1973 and bequeaths $10,000 to M, an organization described in section 501(c)(3), and the residue of his estate to W, his wife. A deduction for the charitable bequest was allowed to X's estate under section 2055. Substantially all of X's estate consists of 100 percent of the stock of a wholly owned corporation, certain liquid assets such as marketable stocks and securities and bank accounts, and X's home, automobile, and other personal property. X's will gives his executor a full range of powers, including the power to sell the stock of the wholly owned corporation. After the death of X, his executor continues to manage the wholly owned corporation while attempting to sell the stock of the corporation. During this period, the executor makes no distributions to M. On May 24, 1978, the Internal Revenue Service determines under § 1.641(b)–3(a) that the administration of the estate has been unduly prolonged and the estate is considered terminated as of that date for Federal income tax purposes. X's estate will be treated as a split-interest trust described in section 4947(a)(2) between May 24, 1978 and the date on which the $10,000 bequest to M is satisfied. X's estate will therefore be subject to the applicable private foundation provisions during that period and, for example, a sale of the house by the estate to any disqualified person (as defined in section 4946) will be an act of self-dealing under section 4941.

(iii) *Revocable trusts which become split-interest trusts.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor under the terms of the governing instrument of which the trustee is required to hold some or all of its net assets in trust after becoming irrevocable for both charitable and noncharitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a reasonable period of settlement after becoming irrevocable except that section 4941 may apply if the requirements of § 53.4941(d)–1(b)(3) are not met.

After that period, the trust is considered a split-interest trust under section 4947(a)(2). For purposes of this (iii), the term *reasonable period of settlement* means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of rights of the subsequent beneficiaries.

(iv) *Certain revocable and testamentary trusts which wind up.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a reasonable period of settlement (within the meaning of paragraph (c)(6)(iii) of this section) after becoming irrevocable. After that period, the

trust is considered a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4947(a)(1), if applicable).

(d) *Cross references; Governing instrument requirements and charitable deduction limitations.* For the application of section 642(c)(6) (relating to section 170 limitations on charitable deductions of non-exempt private foundation trusts) to a trust described in section 4947(a)(1), see § 1.642(c)–4. For the denial of a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 for a gift, a bequest, or an amount paid to (and the denial of a deduction under section 642(c) for an amount set aside in) a trust described in section 4947(a)(1) or (2) that fails to meet the applicable governing instrument requirements of section 508(e) by the end of the taxable year of the trust, see section 508(d)(2) and § 1.508–2(b). Since a charitable remainder trust (as defined in section 664) is not exempt under section 501(a), it is subject to section 4947(a)(2), and thus to the governing instrument requirements of section 508(e) to the extent they are applicable.

(e) *Application of section 507(a)*—(1) *General rule.* The provisions of section 507(a) shall not apply to a trust described in section 4947(a) (1) or (2) by reason of any payment to a beneficiary that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee or, in the case of a discretionary payment, by reason of, or following, the expiration of the last remaining charitable interest in the trust.

(2) *Examples.* The provisions of this (e) may be illustrated by the following examples:

Example 1. H creates a section 4947(a)(1) trust under which the income is to be paid for 15 years to R, a section 501(c)(3) organization. Upon the expiration of 15 years, the trust is to terminate and distribute all of its assets to S, another section 501(c)(3) organization. Distribution of the corpus of the trust to S will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example 2. H creates a trust under which X, a section 501(c)(3) organization, receives $20,000 per year for a period of 20 years, remainder to S, H's son. H is allowed a deduction under section 2522 for the present value of X's interest.

When the final payment to X has been made at the end of the 20-year period in accordance with the terms of the trust, the provisions of section 4947(a)(2) will cease to apply to the trust because the trust no longer retains any amounts for which the deduction under section 2522 was allowed. However, the final payment to X will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example 3. J creates a charitable remainder annuity trust described in section 664(d)(1) under which S, J's son, receives $10,000 per year for life, remainder to be distributed outright to P, an organization described in section 501(c)(3). J is allowed a deduction under section 170 for the value of the remainder interest placed in trust for the benefit of P, and the provisions of section 4947(a)(2) apply to the trust. At the death of S, the trust will terminate and all assets will be distributed to P. However, such final distribution to P will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

[T.D. 7431, 41 FR 35515, Aug. 23, 1976]

§ 53.4947–2 Special rules.

(a) *Limit to segregated amounts.* If any amounts held in trust are segregated within the meaning of § 53.4947–1(c)(3), the value of the net assets for purposes of section 507(c)(2) and (g) shall be limited to the segregated amounts with respect to which a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 was allowed. See the regulations under section 507(c)(2) and (g).

(b) *Applicability of section 4943 and 4944 to split-interests trusts*—(1) *General rule.* Under section 4947(b)(3), section 4943 and 4944 do not apply to a split-interest trust described in section 4947(a)(2) if:

(i) All the income interest (and none of the remainder interest) of the trust is devoted solely to one or more of the purposes described in section 170(c)(2)(B) and all amounts in the trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 have an aggregate value (at the time for which the deduction was allowed) of not more than 60 percent of the aggregate fair market value of all amounts in the trust (after the payment of estate taxes and all other liabilities), or

(ii) A deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2522 for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary.

This (1) shall apply to a trust described in paragraph (b)(1)(ii) of this section only if all amounts payable under the terms of the trust to every remainder beneficiary are to be devoted solely to one or more of the purposes described in section 170(c)(2)(B). After the expiration of all income interests in a trust described in paragraph (b)(1)(ii) of this section, the trust shall become subject to section 4947(a)(1) under § 53.4947–1(b)(2), and section 4947(b)(3) shall no longer apply to the trust. A pooled income fund described in section 642(c)(5) will generally meet the requirements of paragraph (b)(1)(ii) of this section, as will a charitable remainder trust described in section 664(d)(1), if in either case it does not make payments to any income beneficiary described in section 170(c).

(2) *Definitions*. (i) For purposes of section 4947(b)(3)(A), the term ''income interest'' shall include an interest in property transferred in trust which is in the form of a guaranteed annuity interest or unitrust interest as described in § 1.170A–6(c), § 20.2055–2(e)(2) or § 25.2522(c)–3(c)(2) and the term ''remainder interest'' shall include an interest which succeeds an ''income interest'' within the meaning of this (i).

(ii) For purposes of section 4947(b)(3)(B), the term ''income beneficiary'' shall include a recipient of payments described in section 642(c)(5)(F) from a pooled income fund, payments described in section 664(d)(1)(A) from a charitable remainder annuity trust, or payments described in section 664(d)(2)(A) or (3) from a charitable remainder unitrust. The term ''remainder beneficiary'' shall include a beneficiary of a remainder interest described in section 642(c)(5) or 664(d)(1)(C) or (2)(C).

(c) *Effective date*. Except as otherwise provided in §§ 53.4947–1 and 53.4947–2 and the regulations under sections 508 (d) and (e), §§ 53.4947–1 and 53.4947–2 shall take effect on January 1, 1970.

(Secs. 4947 and 7805, Internal Revenue Code of 1954 (68A Stat. 917: 26 U.S.C. 7805))

[T.D. 7431, 41 FR 35515, Aug. 23, 1976]

Subpart I—Tax on Investment Income of and Denial of Exemption to Certain Foreign Organizations

§ 53.4948–1 Application of taxes and denial of exemption with respect to certain foreign organizations.

(a) *Tax on income of certain foreign organizations*. (1) In lieu of the tax imposed by section 4940 and the regulations thereunder, there is hereby imposed for each taxable year beginning after December 31, 1969, on the gross investment income (within the meaning of section 4940(c)(2) and the regulations thereunder) derived from sources within the United States (within the meaning of section 861 and the regulations thereunder) by every foreign organization which is a private foundation (within the meaning of section 509 and the regulations thereunder) and exempt from taxation under section 501(a) for the taxable year a tax equal to 4 percent of such income, except as provided in subparagraph (3) of this paragraph. The tax (if any) will be reported on the form the foundation is required to file under section 6033 and will be paid annually for the taxable year, at the time prescribed for filing such annual return (determined without regard to any extension of time for filing). For purposes of this section, the term *foreign organization* means any organization which is not described in section 170(o)(2)(A).

(2) With respect to the deduction and withholding of tax imposed by section 4948(a), see section 1443(b) and the regulations thereunder.

(3) Whenever there exists a tax treaty between the United States and a foreign country, and a foreign private foundation subject to section 4948(a) is a resident of such country or is otherwise entitled to the benefits of such treaty (whether or not such benefits are available to all residents), if the treaty provides that any item or items

(or all items with respect to an organization exempt from income taxation) of gross investment income (within the meaning of section 4940(c)(2)) shall be exempt from income tax, such item or items shall not be taken into account by such foundation in computing the tax to be imposed under section 4948(a) for any taxable year for which the treaty is effective.

(b) *Certain sections inapplicable.* Section 507 (relating to termination of private foundation status), section 508 (relating to special rules with respect to section 501(c)(3) organizations), and Chapter 42 (other than section 4948) of the Code shall not apply to any foreign organization which from the date of its creation has received at least 85 percent of its support (as defined in section 509(d), other than section 509(d)(4)) from sources outside the United States. For purposes of this paragraph, gifts, grants, contributions, or membership fees directly or indirectly from a United States person (as defined in section 7701(a)(30)) are from sources within the United States.

(c) *Denial of exemption to foreign organizations engaged in prohibited transactions*—(1) *In general.* A foreign private foundation described in section 4948(b) and paragraph (b) of this section shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction (within the meaning of subparagraph (2) of this paragraph) after December 31, 1969.

(2) *Prohibited transactions.* (i) For purposes of this section, the term ''prohibited transaction'' means any act or failure to act (other than with respect to section 4942(e), relating to minimum investment return) which would subject a foreign private foundation described in paragraph (b) of this section, or a disqualified person (as defined in section 4946) with respect thereto, to liability for a penalty under section 6684 (relating to assessable penalties with respect to liability for tax under Chapter 42) or a tax under section 507 (relating to termination of private foundation status) if such foreign private foundation were a domestic private foundation.

(ii) For purposes of subdivision (i) of this subparagraph:

(*a*) Approval by an appropriate foreign government of grants by the foreign private foundation to individuals is sufficient to satisfy the requirements of section 4945(g) and the regulations thereunder.

(*b*) In determining whether a grantee of the foreign organization is a private foundation which is not an operating foundation for purposes of section 4942(g)(1)(A)(ii) or is an organization which is not described in section 509(a)(1), (2), or (3) for purposes of section 4945 (d)(4) and (h), a determination made by such foreign organization will be accepted if such determination is made in good faith after a reasonable effort to identify the status of its grantee.

(iii) For purposes of subdivision (i) of this subparagraph, in order for an act or failure to act (without regard to section 4942(e)) to be treated as a prohibited transaction under section 4948(c)(2) by reason of the application of section 6684(1), there must have been a prior act or failure to act (without regard to section 4942(e)), which:

(*a*) Would have resulted in liability for tax under Chapter 42 (other than section 4940 or 4948(a)) if the foreign private foundation had been a domestic private foundation, and

(*b*) Had been the subject of a warning from the Commissioner that a second act or failure to act (without regard to section 4942(e)) would result in a prohibited transaction.

The second act or failure to act (with respect to which a warning described in subparagraph (3)(i) of this paragraph is given) need not be related to the prior act or failure to act with respect to which a warning from the Commissioner was given under (*b*) of this subdivision.

(3) *Taxable years affected.* (i) Except as provided in subdivision (ii) of this subparagraph, a foreign private foundation described in paragraph (b) of this section shall be denied exemption from taxation under section 501(a) by reason of subparagraph (1) of this paragraph for all taxable years beginning with the taxable year during which it is notified by the Commissioner that it has engaged in a prohibited transaction. The Commissioner shall publish such notice in the FEDERAL REGISTER on the day on

which he so notifies such foreign private foundation. In the case of an act or failure to act (without regard to section 4942(e)) which would result in a penalty under section 6684(1) if the foreign private foundation were a domestic private foundation, before giving notice under this subdivision the Commissioner shall warn such foreign private foundation that such act or failure to act may be treated as a prohibited transaction. However, such act or failure to act will not be treated as a prohibited transaction if it is corrected (within the meaning of Chapter 42 and the regulations thereunder) within 90 days after the making of such warning.

(ii)(*a*) Any foreign private foundation described in paragraph (b) of this section which is denied exemption from taxation under section 501(a) by reason of subparagraph (1) of this paragraph may, with respect to the second taxable year following the taxable year in which notice is given under subdivision (i) of this subparagraph (or any taxable year subsequent to such second taxable year), file a request for exemption from taxation under section 501(a) on Form 1023. In addition to the information generally required of an organization requesting exemption as an organization described in section 501(a), a request under this subdivision must contain or have attached to it a written declaration, made under the penalties of perjury, by a principal officer of such organization authorized to make such declaration, that the organization will not knowingly again engage in a prohibited transaction.

(*b*) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction and that the organization has satisfied all other requirements under section 501, the organization will be so notified in writing. In such case the organization shall not, with respect to taxable years beginning with the taxable year with respect to which a request under this subdivision is filed, be denied exemption from taxation under section 501(a) by reason of any prohibited transaction which was engaged in before the date on which notice was given under subdivision (i) of this subparagraph. Section 4948(c) provides that an organization denied exemption under such section will not be exempt from taxation under section 501(a) for the taxable year in which notice of loss of exemption is given and at least one immediately subsequent taxable year.

(d) *Disallowance of certain charitable deductions*. No gift, bequest, legacy, devise, or transfer shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if made:

(1) To a foreign private foundation described in paragraph (b) of this section after the date on which the Commissioner publishes notice under paragraph (c)(3)(i) of this section that he has notified such organization that it has engaged in a prohibited transaction, and

(2) In a taxable year of such organization for which it is not exempt from taxation under section 501(a) by reason of paragraph (c)(1) of this section.

For purposes of this paragraph, a bequest, legacy, devise, or transfer under section 2055 or 2106(a)(2) shall be treated as made on the date of death of the decedent. For example, assume that an individual gives money to a foreign private foundation described in section 4948(b) in January 1970, January 1971, and January 1972. The organization has a taxable year from June 1 through May 31. In February 1970, notice is duly published that the foreign organization has engaged in a prohibited transaction. In December 1970, the organization duly submits a request for exemption under paragraph (c)(3)(ii)(*a*) of this section which is granted for the taxable year ending May 31, 1972. The January 1970 gift is allowable as a deduction under section 2522 since it was made before the notice (February 1970). The January 1971 gift is not allowable as a deduction because the taxable year ending May 31, 1971, is a nonexempt year (the first taxable year subsequent to the taxable year of the notice) for the foreign organization. The January 1972 gift is allowable as a deduction under section 2522 because the taxable year ending May 31, 1972, is an exempt year for the organization.

[T.D. 7218, 37 FR 23918, Nov. 10, 1972; 37 FR 24748, Nov. 21, 1972; 38 FR 4324, Feb. 13, 1973]

Subpart J—Black Lung Benefit Trust Excise Taxes

SOURCE: T.D. 7644, 44 FR 52198, Sept. 7, 1979, unless otherwise noted.

§ 53.4951–1 Black lung trusts—taxes on self-dealing.

(a) *In general.* Section 4951 contains provisions that correspond to provisions of section 4941 (relating to taxes on foundation self-dealing) and section 4946 (relating to definitions and special rules). Regulations and rulings under these corresponding provisions apply to section 4951 where appropriate.

(b) *Transfer of property to trust.* A transfer of personal property without consideration to a trust for which a deduction is allowable under section 192 does not constitute a sale or exchange for purposes of section 4951 unless the property is subject to a mortgage or similar lien within section 4951(d)(2)(A). The transfer to a trust of a note or other evidence of indebtedness constitutes an extension of credit to the obligor for purposes of section 4951(d)(1)(B).

(c) *Deposits.* A time or demand deposit made with a bank or credit union that is a trustee or other disqualified person with respect to a trust constitutes a lending of money for purposes of section 4951(d)(1)(B) even though the deposit is of a kind generally authorized for investments by the trust.

(d) *Trustee.* The term ''trustee'' as used in section 4951(e)(5)(B) includes any person having powers or responsibilities with respect to a trust similar to those of trustees.

(e) *Misallocation of insurance premium.* Under section 501(c)(21)(A)(ii) and § 1.501(c)(21)-1(d), a trust may pay a portion of a premium for insurance which covers both black lung liabilities and other liabilities, so long as the requirements of section 501(c)(21)(A)(i) concerning allocation of the total premium are met. However, if an insurance company misallocates the total premium in a manner which benefits a disqualified person, the amount of misallocation constitutes a use of trust assets for the benefit of the disqualified person within section 4951(d)(1)(D). For these purposes, it is irrelevant whether the combination of insurance is sold under one policy or more than one policy.

(f) *Effective date.* Section 4951 applies with respect to acts that occur after December 31, 1977, in and for trust *taxable* years beginning after December 31, 1977.

§ 53.4952–1 Black lung trusts—taxes on taxable expenditures.

(a) *In general.* Section 4952 contains provisions that generally correspond to provisions of section 4945 (relating to taxes on taxable expenditures by private foundations) and section 4946 (relating to definitions and special rules). Regulations and rulings under these corresponding provisions apply to section 4952 where appropriate. See section 4952(e)(1) for the definition of *correction*.

(b) *Unauthorized investments.* The term ''taxable expenditure'' in section 4952(d) includes an investment that is not authorized under section 501(c)(21)(B)(ii).

(c) *Effective date.* Section 4952 applies with respect to expenditures made after December 31, 1977, in and for trust taxable years beginning after December 31, 1977.

Subpart K—Second Tier Excise Taxes

SOURCE: T.D. 8084, 51 FR 16303, May 2, 1986, unless otherwise noted.

§ 53.4955–1 Tax on political expenditures.

(a) *Relationship between section 4955 excise taxes and substantive standards for exemption under section 501(c)(3).* The excise taxes imposed by section 4955 do not affect the substantive standards for tax exemption under section 501(c)(3), under which an organization is described in section 501(c)(3) only if it does not participate or intervene in any political campaign on behalf of any candidate for public office.

(b) *Imposition of initial taxes on organization managers*—(1) *In general.* The excise tax under section 4955(a)(2) on the agreement of any organization manager to the making of a political expenditure by a section 501(c)(3) organization is imposed only in cases where—

(i) A tax is imposed by section 4955(a)(1);

(ii) The organization manager knows that the expenditure to which the manager agrees is a political expenditure; and

(iii) The agreement is willful and is not due to reasonable cause.

(2) *Type of organization managers covered*—(i) *In general*. The tax under section 4955(a)(2) is imposed only on those organization managers who are authorized to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the organization and on those organization managers who are members of a group (such as the organization's board of directors or trustees) which is so authorized.

(ii) *Officer*. For purposes of section 4955(f)(2)(A), a person is an officer of an organization if—

(A) That person is specifically so designated under the certificate of incorporation, bylaws, or other constitutive documents of the foundation; or

(B) That person regularly exercises general authority to make administrative or policy decisions on behalf of the organization. Independent contractors, acting in a capacity as attorneys, accountants, and investment managers and advisors, are not officers. With respect to any expenditure, any person described in this paragraph (b)(2)(ii)(B) who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer.

(iii) *Employee*. For purposes of section 4955(f)(2)(B), an individual rendering services to an organization is an employee of the organization only if that individual is an employee within the meaning of section 3121(d)(2). With respect to any expenditure, an employee (other than an officer, director, or trustee of the organization) is described in section 4955(f)(2)(B) only if he or she has final authority or responsibility (either officially or effectively) with respect to such expenditure.

(3) *Type of agreement required*. An organization manager agrees to the making of a political expenditure if the manager manifests approval of the expenditure which is sufficient to constitute an exercise of the organization manager's authority to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the organization. The manifestation of approval need not be the final or decisive approval on behalf of the organization.

(4) *Knowing*—(i) *General rule*. For purposes of section 4955, an organization manager is considered to have agreed to an expenditure *knowing* that it is a political expenditure only if—

(A) The manager has actual knowledge of sufficient facts so that, based solely upon these facts, the expenditure would be a political expenditure;

(B) The manager is aware that such an expenditure under these circumstances may violate the provisions of federal tax law governing political expenditures; and

(C) The manager negligently fails to make reasonable attempts to ascertain whether the expenditure is a political expenditure, or the manager is aware that it is a political expenditure.

(ii) *Amplification of general rule*. For purposes of section 4955, knowing does not mean having reason to know. However, evidence tending to show that an organization manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of the fact or rule. Thus, for example, evidence tending to show that an organization manager has reason to know of sufficient facts so that, based solely upon those facts, an expenditure would be a political expenditure is relevant in determining whether the manager has actual knowledge of the facts.

(5) *Willful*. An organization manager's agreement to a political expenditure is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an agreement willful. However, an organization manager's agreement to a political expenditure is not willful if the manager does not know that it is a political expenditure.

(6) *Due to reasonable cause*. An organization manager's actions are due to

reasonable cause if the manager has exercised his or her responsibility on behalf of the organization with ordinary business care and prudence.

(7) *Advice of counsel.* An organization manager's agreement to an expenditure is ordinarily not considered knowing or willful and is ordinarily considered due to reasonable cause if the manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of counsel expressed in a reasoned written legal opinion that an expenditure is not a political expenditure under section 4955 (or that expenditures conforming to certain guidelines are not political expenditures). For this purpose, a written legal opinion is considered reasoned even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion addresses itself to the facts and applicable law. A written legal opinion is not considered reasoned if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an expenditure does not, by itself, give rise to any inference that an organization manager agreed to the making of the expenditure knowingly, willfully, or without reasonable cause.

(8) *Cross reference.* For provisions relating to the burden of proof in cases involving the issue of whether an organization manager has knowingly agreed to the making of a political expenditure, see section 7454(b).

(c) *Amplification of political expenditure definition*—(1) *General rule.* Any expenditure that would cause an organization that makes the expenditure to be classified as an action organization by reason of §1.501(c)(3)–1(c)(3)(iii) of this chapter is a political expenditure within the meaning of section 4955(d)(1).

(2) *Other political expenditures*—(i) For purposes of section 4955(d)(2), an organization is effectively controlled by a candidate or prospective candidate only if the individual has a continuing, substantial involvement in the day-to-day operations or management of the organization. An organization is not effectively controlled by a candidate or a prospective candidate merely because it is affiliated with the candidate, or merely because the candidate knows the directors, officers, or employees of the organization. The effectively controlled test is not met merely because the organization carries on its research, study, or other educational activities with respect to subject matter or issues in which the individual is interested or with which the individual is associated.

(ii) For purposes of section 4955(d)(2), a determination of whether the primary purpose of an organization is promoting the candidacy or prospective candidacy of an individual for public office is made on the basis of all the facts and circumstances. The factors to be considered include whether the surveys, studies, materials, etc. prepared by the organization are made available only to the candidate or are made available to the general public; and whether the organization pays for speeches and travel expenses for only one individual, or for speeches or travel expenses of several persons. The fact that a candidate or prospective candidate utilizes studies, papers, materials, etc., prepared by the organization (such as in a speech by the candidate) is not to be considered as a factor indicating that the organization has a purpose of promoting the candidacy or prospective candidacy of that individual where such studies, papers, materials, etc. are not made available only to that individual.

(iii) Expenditures for voter registration, voter turnout, or voter education constitute other expenses, treated as political expenditures by reason of section 4955(d)(2)(E), only if the expenditures violate the prohibition on political activity provided in section 501(c)(3).

(d) *Abatement, refund, or no assessment of initial tax.* No initial (first-tier) tax will be imposed under section 4955(a), or the initial tax will be abated or refunded, if the organization or an organization manager establishes to the satisfaction of the IRS that—

(1) The political expenditure was not willful and flagrant; and

(2) The political expenditure was corrected.

(e) *Correction*—(1) *Recovery of Expenditure.* For purposes of section 4955(f)(3)

and this section, correction of a political expenditure is accomplished by recovering part or all of the expenditure to the extent recovery is possible, and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe. The organization making the political expenditure is not under any obligation to attempt to recover the expenditure by legal action if the action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Establishing safeguards*. Correction of a political expenditure must also involve the establishment of sufficient safeguards to prevent future political expenditures by the organization. The determination of whether safeguards are sufficient to prevent future political expenditures by the organization is made by the District Director.

(f) *Effective date*. This section is effective December 5, 1995.

[T.D. 8628, 60 FR 62210, Dec. 5, 1995]

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[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–1 Taxes on excess benefit transactions.

(a) *In general.* Section 4958 imposes excise taxes on each excess benefit transaction (as defined in section 4958(c) and § 53.4958–4) between an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958–2) and a disqualified person (as defined in section 4958(f)(1) and § 53.4958–3). A disqualified person who receives an excess benefit from an excess benefit transaction is liable for payment of a section 4958(a)(1) excise tax equal to 25 percent of the excess benefit. If an initial tax is imposed by section 4958(a)(1) on an excess benefit transaction and the transaction is not corrected (as defined in section 4958(f)(6) and § 53.4958–7) within the taxable period (as defined in section 4958(f)(5) and paragraph (c)(2)(ii) of this section), then any disqualified person who received an excess benefit from the excess benefit transaction on which the initial tax was imposed is liable for an additional tax of 200 percent of the excess benefit. An organization manager (as defined in section 4958(f)(2) and paragraph (d) of this section) who participates in an excess benefit transaction, knowing that it was such a transaction, is liable for payment of a section 4958(a)(2) excise tax equal to 10 percent of the excess benefit, unless the participation was not willful and was due to reasonable cause. If an organization manager also receives an excess benefit from an excess benefit transaction, the manager may be liable for both taxes imposed by section 4958(a).

(b) *Excess benefit defined.* An excess benefit is the amount by which the value of the economic benefit provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefit.

(c) *Taxes paid by disqualified person*—(1) *Initial tax.* Section 4958(a)(1) imposes a tax equal to 25 percent of the excess benefit on each excess benefit transaction. The section 4958(a)(1) tax shall be paid by any disqualified person who received an excess benefit from that excess benefit transaction. With respect to any excess benefit transaction, if more than one disqualified person is liable for the tax imposed by section 4958(a)(1), all such persons are jointly and severally liable for that tax.

(2) *Additional tax on disqualified person*—(i) *In general.* Section 4958(b) imposes a tax equal to 200 percent of the excess benefit in any case in which section 4958(a)(1) imposes a 25-percent tax on an excess benefit transaction and the transaction is not corrected (as defined in section 4958(f)(6) and § 53.4958–7) within the taxable period (as defined in section 4958(f)(5) and paragraph (c)(2)(ii) of this section). If a disqualified person makes a payment of less than the full correction amount under the rules of § 53.4958–7, the 200-percent tax is imposed only on the unpaid portion of the correction amount (as described in § 53.4958–7(c)). The tax imposed by section 4958(b) is payable by any disqualified person who received an excess benefit from the excess benefit transaction on which the initial tax was imposed by section 4958(a)(1). With respect to any excess benefit transaction, if more than one disqualified person is liable for the tax imposed by section 4958(b), all such persons are jointly and severally liable for that tax.

(ii) *Taxable period. Taxable period* means, with respect to any excess benefit transaction, the period beginning with the date on which the transaction occurs and ending on the earlier of—

(A) The date of mailing a notice of deficiency under section 6212 with respect to the section 4958(a)(1) tax; or

(B) The date on which the tax imposed by section 4958(a)(1) is assessed.

(iii) *Abatement if correction during the correction period.* For rules relating to abatement of taxes on excess benefit transactions that are corrected within the correction period, as defined in section 4963(e), see sections 4961(a), 4962(a), and the regulations thereunder. The abatement rules of section 4961 specifically provide for a 90-day correction period after the date of mailing a notice of deficiency under section 6212 with respect to the section 4958(b) 200-percent tax. If the excess benefit is corrected during that correction period, the 200-percent tax imposed shall not be assessed, and if assessed the assessment shall be abated, and if collected

shall be credited or refunded as an overpayment. For special rules relating to abatement of the 25-percent tax, see section 4962.

(d) *Tax paid by organization managers*—(1) *In general.* In any case in which section 4958(a)(1) imposes a tax, section 4958(a)(2) imposes a tax equal to 10 percent of the excess benefit on the participation of any organization manager who knowingly participated in the excess benefit transaction, unless such participation was not willful and was due to reasonable cause. Any organization manager who so participated in the excess benefit transaction must pay the tax.

(2) *Organization manager defined*—(i) *In general.* An organization manager is, with respect to any applicable tax-exempt organization, any officer, director, or trustee of such organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title. A person is an officer of an organization if that person—

(A) Is specifically so designated under the certificate of incorporation, by-laws, or other constitutive documents of the organization; or

(B) Regularly exercises general authority to make administrative or policy decisions on behalf of the organization. A contractor who acts solely in a capacity as an attorney, accountant, or investment manager or advisor, is not an officer. For purposes of this paragraph (d)(2)(i)(B), any person who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer.

(ii) *Special rule for certain committee members.* An individual who is not an officer, director, or trustee, yet serves on a committee of the governing body of an applicable tax-exempt organization (or as a designee of the governing body described in § 53.4958–6(c)(1)) that is attempting to invoke the rebuttable presumption of reasonableness described in § 53.4958–6 based on the committee's (or designee's) actions, is an organization manager for purposes of the tax imposed by section 4958(a)(2).

(3) *Participation.* For purposes of section 4958(a)(2) and this paragraph (d), participation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager. An organization manager is not considered to have participated in an excess benefit transaction, however, where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the applicable tax-exempt organization.

(4) *Knowing*—(i) *In general.* For purposes of section 4958(a)(2) and this paragraph (d), a manager participates in a transaction knowingly only if the person—

(A) Has actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction;

(B) Is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and

(C) Negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.

(ii) *Amplification of general rule. Knowing* does not mean having reason to know. However, evidence tending to show that a manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a manager has reason to know of sufficient facts so that, based solely upon such facts, a transaction would be an excess benefit transaction is relevant in determining whether the manager has actual knowledge of such facts.

(iii) *Reliance on professional advice.* An organization manager's participation in a transaction is ordinarily not considered knowing within the meaning of section 4958(a)(2), even though the transaction is subsequently held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of

that professional with respect to elements of the transaction within the professional's expertise. For purposes of section 4958(a)(2) and this paragraph (d), a written opinion is reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. However, a written opinion is not reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction shall not, by itself, however, give rise to any inference that an organization manager participated in the transaction knowingly. For purposes of this paragraph, appropriate professionals on whose written opinion an organization manager may rely, are limited to—

(A) Legal counsel, including in-house counsel;

(B) Certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and

(C) Independent valuation experts who—

(*1*) Hold themselves out to the public as appraisers or compensation consultants;

(*2*) Perform the relevant valuations on a regular basis;

(*3*) Are qualified to make valuations of the type of property or services involved; and

(*4*) Include in the written opinion a certification that the requirements of paragraphs (d)(4)(iii)(C)(*1*) through (*3*) of this section are met.

(iv) *Satisfaction of rebuttable presumption of reasonableness.* An organization manager's participation in a transaction is ordinarily not considered knowing within the meaning of section 4958(a)(2), even though the transaction is subsequently held to be an excess benefit transaction, if the appropriate authorized body has met the requirements of § 53.4958–6(a) with respect to the transaction.

(5) *Willful.* For purposes of section 4958(a)(2) and this paragraph (d), participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.

(6) *Due to reasonable cause.* An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.

(7) *Limits on liability for management.* The maximum aggregate amount of tax collectible under section 4958(a)(2) and this paragraph (d) from organization managers with respect to any one excess benefit transaction is $10,000.

(8) *Joint and several liability.* In any case where more than one person is liable for a tax imposed by section 4958(a)(2), all such persons shall be jointly and severally liable for the taxes imposed under section 4958(a)(2) with respect to that excess benefit transaction.

(9) *Burden of proof.* For provisions relating to the burden of proof in cases involving the issue of whether an organization manager has knowingly participated in an excess benefit transaction, see section 7454(b) and § 301.7454–2 of this chapter. In these cases, the Commissioner bears the burden of proof.

(e) *Date of occurrence*—(1) *In general.* Except as otherwise provided, an excess benefit transaction occurs on the date on which the disqualified person receives the economic benefit for Federal income tax purposes. When a single contractual arrangement provides for a series of compensation or other payments to (or for the use of) a disqualified person over the course of the disqualified person's taxable year (or part of a taxable year), any excess benefit transaction with respect to these aggregate payments is deemed to occur on the last day of the taxable year (or if the payments continue for part of the year, the date of the last payment in the series).

(2) *Special rules.* In the case of benefits provided pursuant to a qualified pension, profit-sharing, or stock bonus plan, the transaction occurs on the date the benefit is vested. In the case of a transfer of property that is subject

to a substantial risk of forfeiture or in the case of rights to future compensation or property (including benefits under a nonqualified deferred compensation plan), the transaction occurs on the date the property, or the rights to future compensation or property, is not subject to a substantial risk of forfeiture. However, where the disqualified person elects to include an amount in gross income in the taxable year of transfer pursuant to section 83(b), the general rule of paragraph (e)(1) of this section applies to the property with respect to which the section 83(b) election is made. Any excess benefit transaction with respect to benefits under a deferred compensation plan which vest during any taxable year of the disqualified person is deemed to occur on the last day of such taxable year. For the rules governing the timing of the reasonableness determination for deferred, contingent, and certain other noncash compensation, see § 53.4958–4(b)(2).

(3) *Statute of limitations rules.* See sections 6501(e)(3) and (l) and the regulations thereunder for statute of limitations rules as they apply to section 4958 excise taxes.

(f) *Effective date for imposition of taxes*—(1) *In general.* The section 4958 taxes imposed on excess benefit transactions or on participation in excess benefit transactions apply to transactions occurring on or after September 14, 1995.

(2) *Existing binding contracts.* The section 4958 taxes do not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs. A written binding contract that is terminable or subject to cancellation by the applicable tax-exempt organization without the disqualified person's consent (including as the result of a breach of contract by the disqualified person) and without substantial penalty to the organization, is no longer treated as a binding contract as of the earliest date that any such termination or cancellation, if made, would be effective. If a binding written contract is materially changed, it is treated as a new contract entered into as of the date the material change is effective. A material change includes an extension or renewal of the contract (other than an extension or renewal that results from the person contracting with the applicable tax-exempt organization unilaterally exercising an option expressly granted by the contract), or a more than incidental change to any payment under the contract.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–2 Definition of applicable tax-exempt organization.

(a) *Organizations described in section 501(c)(3) or (4) and exempt from tax under section 501(a)*—(1) *In general.* An applicable tax-exempt organization is any organization that, without regard to any excess benefit, would be described in section 501(c)(3) or (4) and exempt from tax under section 501(a). An applicable tax-exempt organization also includes any organization that was described in section 501(c)(3) or (4) and was exempt from tax under section 501(a) at any time during a five-year period ending on the date of an excess benefit transaction (the lookback period).

(2) *Exceptions from definition of applicable tax-exempt organization*—(i) *Private foundation.* A private foundation as defined in section 509(a) is not an applicable tax-exempt organization for section 4958 purposes.

(ii) *Governmental unit or affiliate.* A governmental unit or an affiliate of a governmental unit is not an applicable tax-exempt organization for section 4958 purposes if it is—

(A) Exempt from (or not subject to) taxation without regard to section 501(a); or

(B) Relieved from filing an annual return pursuant to the authority of § 1.6033–2(g)(6).

(3) *Organizations described in section 501(c)(3).* An organization is described in section 501(c)(3) for purposes of section 4958 only if the organization—

(i) Provides the notice described in section 508; or

(ii) Is described in section 501(c)(3) and specifically is excluded from the requirements of section 508 by that section.

(4) *Organizations described in section 501(c)(4).* An organization is described

in section 501(c)(4) for purposes of section 4958 only if the organization—

(i) Has applied for and received recognition from the Internal Revenue Service as an organization described in section 501(c)(4); or

(ii) Has filed an application for recognition under section 501(c)(4) with the Internal Revenue Service, has filed an annual information return as a section 501(c)(4) organization under the Internal Revenue Code or regulations promulgated thereunder, or has otherwise held itself out as being described in section 501(c)(4) and exempt from tax under section 501(a).

(5) *Effect of non-recognition or revocation of exempt status.* An organization is not described in paragraph (a)(3) or (4) of this section during any period covered by a final determination or adjudication that the organization is not exempt from tax under section 501(a) as an organization described in section 501(c)(3) or (4), so long as that determination or adjudication is not based upon participation in inurement or one or more excess benefit transactions. However, the organization may be an applicable tax-exempt organization for that period as a result of the five-year lookback period described in paragraph (a)(1) of this section.

(6) *Examples.* The following examples illustrate the principles of this section, which defines an applicable tax-exempt organization for purposes of section 4958:

Example 1. O is a nonprofit corporation formed under state law. O filed its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). In its application, O described its plans for purchasing property from some of its directors at prices that would exceed fair market value. After reviewing the application, the IRS determined that because of the proposed property purchase transactions, O failed to establish that it met the requirements for an organization described in section 501(c)(3). Accordingly, the IRS denied O's application. While O's application was pending, O engaged in the purchase transactions described in its application at prices that exceeded the fair market values of the properties. Although these transactions would constitute excess benefit transactions under section 4958, because the IRS never recognized O as an organization described in section 501(c)(3), O was never an applicable tax-exempt organization under section 4958. Therefore, these transactions are not subject to the excise taxes provided in section 4958.

Example 2. O is a nonprofit corporation formed under state law. O files its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). The IRS issues a favorable determination letter in Year 1 that recognizes O as an organization described in section 501(c)(3). Subsequently, in Year 5 of O's operations, O engages in certain transactions that constitute excess benefit transactions under section 4958 and violate the proscription against inurement under section 501(c)(3) and § 1.501(c)(3)–1(c)(2). The IRS examines the Form 990, ''Return of Organization Exempt From Income Tax'', that O filed for Year 5. After considering all the relevant facts and circumstances in accordance with § 1.501(c)(3)–1(f), the IRS concludes that O is no longer described in section 501(c)(3) effective in Year 5. The IRS does not examine the Forms 990 that O filed for its first four years of operations and, accordingly, does not revoke O's exempt status for those years. Although O's tax-exempt status is revoked effective in Year 5, under the *lookback* rules in paragraph (a)(1) of this section and § 53.4958–3(a)(1) of this chapter, during the five-year period prior to the excess benefit transactions that occurred in Year 5, O was an applicable tax-exempt organization and O's directors were disqualified persons as to O. Therefore, the transactions between O and its directors during Year 5 are subject to the applicable excise taxes provided in section 4958.

(b) *Special rules*—(1) *Transition rule for lookback period.* In the case of any excess benefit transaction occurring before September 14, 2000, the lookback period described in paragraph (a)(1) of this section begins on September 14, 1995, and ends on the date of the transaction.

(2) *Certain foreign organizations.* A foreign organization, recognized by the Internal Revenue Service or by treaty, that receives substantially all of its support (other than gross investment income) from sources outside of the United States is not an organization described in section 501(c)(3) or (4) for purposes of section 4958.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002, as amended by T.D. 9390, 73 FR 16524, Mar. 28, 2008]

§ 53.4958–3 Definition of disqualified person.

(a) *In general*—(1) *Scope of definition.* Section 4958(f)(1) defines *disqualified person,* with respect to any transaction,

as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction (the lookback period). Paragraph (b) of this section describes persons who are defined to be disqualified persons under the statute, including certain family members of an individual in a position to exercise substantial influence, and certain 35-percent controlled entities. Paragraph (c) of this section describes persons in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization by virtue of their powers and responsibilities or certain interests they hold. Paragraph (d) of this section describes persons deemed not to be in a position to exercise substantial influence. Whether any person who is not described in paragraph (b), (c) or (d) of this section is a disqualified person with respect to a transaction for purposes of section 4958 is based on all relevant facts and circumstances, as described in paragraph (e) of this section. Paragraph (f) of this section describes special rules for affiliated organizations. Examples in paragraph (g) of this section illustrate these categories of persons.

(2) *Transition rule for lookback period.* In the case of any excess benefit transaction occurring before September 14, 2000, the lookback period described in paragraph (a)(1) of this section begins on September 14, 1995, and ends on the date of the transaction.

(b) *Statutory categories of disqualified persons*—(1) *Family members.* A person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is a member of the family of a person who is a disqualified person described in paragraph (a) of this section (other than as a result of this paragraph) with respect to any transaction with the same organization. For purposes of the following sentence, a legally adopted child of an individual is treated as a child of such individual by blood. A person's family is limited to—

(i) Spouse;

(ii) Brothers or sisters (by whole or half blood);

(iii) Spouses of brothers or sisters (by whole or half blood);

(iv) Ancestors;

(v) Children;

(vi) Grandchildren;

(vii) Great grandchildren; and

(viii) Spouses of children, grandchildren, and great grandchildren.

(2) *Thirty-five percent controlled entities*—(i) *In general.* A person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is a 35-percent controlled entity. A 35-percent controlled entity is—

(A) A corporation in which persons described in this section (except in paragraphs (b)(2) and (d) of this section) own more than 35 percent of the combined voting power;

(B) A partnership in which persons described in this section (except in paragraphs (b)(2) and (d) of this section) own more than 35 percent of the profits interest; or

(C) A trust or estate in which persons described in this section (except in paragraphs (b)(2) and (d) of this section) own more than 35 percent of the beneficial interest.

(ii) *Combined voting power.* For purposes of this paragraph (b)(2), combined voting power includes voting power represented by holdings of voting stock, direct or indirect, but does not include voting rights held only as a director, trustee, or other fiduciary.

(iii) *Constructive ownership rules*—(A) *Stockholdings.* For purposes of section 4958(f)(3) and this paragraph (b)(2), indirect stockholdings are taken into account as under section 267(c), except that in applying section 267(c)(4), the family of an individual shall include the members of the family specified in section 4958(f)(4) and paragraph (b)(1) of this section.

(B) *Profits or beneficial interest.* For purposes of section 4958(f)(3) and this paragraph (b)(2), the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) (other than section 267(c)(3)), except that in applying section 267(c)(4), the family of an individual shall include the members of the family specified in section 4958(f)(4) and paragraph (b)(1) of this section.

(c) *Persons having substantial influence.* A person who holds any of the following powers, responsibilities, or interests is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization:

(1) *Voting members of the governing body.* This category includes any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority.

(2) *Presidents, chief executive officers, or chief operating officers.* This category includes any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization. A person who serves as president, chief executive officer, or chief operating officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals (e.g., co-presidents), who may exercise such responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.

(3) *Treasurers and chief financial officers.* This category includes any person who, regardless of title, has ultimate responsibility for managing the finances of the organization. A person who serves as treasurer or chief financial officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals who may exercise the responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.

(4) *Persons with a material financial interest in a provider-sponsored organization.* For purposes of section 4958, if a hospital that participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act, 42 U.S.C. 1395w–25) is an applicable tax-exempt organization, then any person with a material financial interest (within the meaning of section 501(o)) in the provider-sponsored organization has substantial influence with respect to the hospital.

(d) *Persons deemed not to have substantial influence.* A person is deemed not to be in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization if that person is described in one of the following categories:

(1) *Tax-exempt organizations described in section 501(c)(3).* This category includes any organization described in section 501(c)(3) and exempt from tax under section 501(a).

(2) *Certain section 501(c)(4) organizations.* Only with respect to an applicable tax-exempt organization described in section 501(c)(4) and § 53.4958–2(a)(4), this category includes any other organization so described.

(3) *Employees receiving economic benefits of less than a specified amount in a taxable year.* This category includes, for the taxable year in which benefits are provided, any full- or part-time employee of the applicable tax-exempt organization who—

(i) Receives economic benefits, directly or indirectly from the organization, of less than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i);

(ii) Is not described in paragraph (b) or (c) of this section with respect to the organization; and

(iii) Is not a substantial contributor to the organization within the meaning of section 507(d)(2)(A), taking into account only contributions received by the organization during its current taxable year and the four preceding taxable years.

(e) *Facts and circumstances govern in all other cases*—(1) *In general.* Whether a person who is not described in paragraph (b), (c) or (d) of this section is a disqualified person depends upon all relevant facts and circumstances.

(2) *Facts and circumstances tending to show substantial influence.* Facts and circumstances tending to show that a person has substantial influence over the affairs of an organization include, but are not limited to, the following—

(i) The person founded the organization;

(ii) The person is a substantial contributor to the organization (within the meaning of section 507(d)(2)(A)), taking into account only contributions received by the organization during its

current taxable year and the four preceding taxable years;

(iii) The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls;

(iv) The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;

(v) The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole;

(vi) The person owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person; or

(vii) The person is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

(3) *Facts and circumstances tending to show no substantial influence.* Facts and circumstances tending to show that a person does not have substantial influence over the affairs of an organization include, but are not limited to, the following—

(i) The person has taken a bona fide vow of poverty as an employee, agent, or on behalf, of a religious organization;

(ii) The person is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the contractor will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);

(iii) The direct supervisor of the individual is not a disqualified person;

(iv) The person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

(v) Any preferential treatment a person receives based on the size of that person's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.

(f) *Affiliated organizations.* In the case of multiple organizations affiliated by common control or governing documents, the determination of whether a person does or does not have substantial influence shall be made separately for each applicable tax-exempt organization. A person may be a disqualified person with respect to transactions with more than one applicable tax-exempt organization.

(g) *Examples.* The following examples illustrate the principles of this section. A finding that a person is a disqualified person in the following examples does not indicate that an excess benefit transaction has occurred. If a person is a disqualified person, the rules of section 4958(c) and § 53.4958–4 apply to determine whether an excess benefit transaction has occurred. The examples are as follows:

Example 1. N, an artist by profession, works part-time at R, a local museum. In the first taxable year in which R employs N, R pays N a salary and provides no additional benefits to N except for free admission to the museum, a benefit R provides to all of its employees and volunteers. The total economic benefits N receives from R during the taxable year are less than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i). The part-time job constitutes N's only relationship with R. N is not related to any other disqualified person with respect to R. N is deemed not to be in a position to exercise substantial influence over the affairs of R. Therefore, N is not a disqualified person with respect to R in that year.

Example 2. The facts are the same as in *Example 1*, except that in addition to the salary that R pays N for N's services during the taxable year, R also purchases one of N's paintings for $x. The total of N's salary plus $x exceeds the amount referenced for highly compensated employees in section 414(q)(1)(B)(i). Consequently, whether N is in a position to exercise substantial influence over the affairs of R for that taxable year depends upon all of the relevant facts and circumstances.

Example 3. Q is a member of K, a section 501(c)(3) organization with a broad-based

public membership. Members of K are entitled to vote only with respect to the annual election of directors and the approval of major organizational transactions such as a merger or dissolution. Q is not related to any other disqualified person of K. Q has no other relationship to K besides being a member of K and occasionally making modest donations to K. Whether Q is a disqualified person is determined by all relevant facts and circumstances. Q's voting rights, which are the same as granted to all members of K, do not place Q in a position to exercise substantial influence over K. Under these facts and circumstances, Q is not a disqualified person with respect to K.

Example 4. E is the headmaster of Z, a school that is an applicable tax-exempt organization for purposes of section 4958. E reports to Z's board of trustees and has ultimate responsibility for supervising Z's day-to-day operations. For example, E can hire faculty members and staff, make changes to the school's curriculum and discipline students without specific board approval. Because E has ultimate responsibility for supervising the operation of Z, E is in a position to exercise substantial influence over the affairs of Z. Therefore, E is a disqualified person with respect to Z.

Example 5. Y is an applicable tax-exempt organization for purposes of section 4958 that decides to use bingo games as a method of generating revenue. Y enters into a contract with B, a company that operates bingo games. Under the contract, B manages the promotion and operation of the bingo activity, provides all necessary staff, equipment, and services, and pays Y *q* percent of the revenue from this activity. B retains the balance of the proceeds. Y provides no goods or services in connection with the bingo operation other than the use of its hall for the bingo games. The annual gross revenue earned from the bingo games represents more than half of Y's total annual revenue. B's compensation is primarily based on revenues from an activity B controls. B also manages a discrete activity of Y that represents a substantial portion of Y's income compared to the organization as a whole. Under these facts and circumstances, B is in a position to exercise substantial influence over the affairs of Y. Therefore, B is a disqualified person with respect to Y.

Example 6. The facts are the same as in *Example 5,* with the additional fact that P owns a majority of the stock of B and is actively involved in managing B. Because P owns a controlling interest (measured by either vote or value) in and actively manages B, P is also in a position to exercise substantial influence over the affairs of Y. Therefore, under these facts and circumstances, P is a disqualified person with respect to Y.

Example 7. A, an applicable tax-exempt organization for purposes of section 4958, owns and operates one acute care hospital. B, a for-profit corporation, owns and operates a number of hospitals. A and B form C, a limited liability company. In exchange for proportional ownership interests, A contributes its hospital, and B contributes other assets, to C. All of A's assets then consist of its membership interest in C. A continues to be operated for exempt purposes based almost exclusively on the activities it conducts through C. C enters into a management agreement with a management company, M, to provide day to day management services to C. Subject to supervision by C's board, M is given broad discretion to manage C's day to day operation and has ultimate responsibility for supervising the management of the hospital. Because M has ultimate responsibility for supervising the management of the hospital operated by C, A's ownership interest in C is its primary asset, and C's activities form the basis for A's continued exemption as an organization described in section 501(c)(3), M is in a position to exercise substantial influence over the affairs of A. Therefore, M is a disqualified person with respect to A.

Example 8. T is a large university and an applicable tax-exempt organization for purposes of section 4958. L is the dean of the College of Law of T, a substantial source of revenue for T, including contributions from alumni and foundations. L is not related to any other disqualified person of T. L does not serve on T's governing body or have ultimate responsibility for managing the university as whole. However, as dean of the College of Law, L plays a key role in faculty hiring and determines a substantial portion of the capital expenditures and operating budget of the College of Law. L's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. L's management of a discrete segment of T that represents a substantial portion of the income of T (as compared to T as a whole) places L in a position to exercise substantial influence over the affairs of T. Under these facts and circumstances L is a disqualified person with respect to T.

Example 9. S chairs a small academic department in the College of Arts and Sciences of the same university T described in *Example 8.* S is not related to any other disqualified person of T. S does not serve on T's governing body or as an officer of T. As department chair, S supervises faculty in the department, approves the course curriculum, and oversees the operating budget for the department. S's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. Even though S manages the department, that department does not represent a substantial

portion of T's activities, assets, income, expenses, or operating budget. Therefore, S does not participate in any management decisions affecting either T as a whole, or a discrete segment or activity of T that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, S does not have substantial influence over the affairs of T, and therefore S is not a disqualified person with respect to T.

Example 10. U is a large acute-care hospital that is an applicable tax-exempt organization for purposes of section 4958. U employs X as a radiologist. X gives instructions to staff with respect to the radiology work X conducts, but X does not supervise other U employees or manage any substantial part of U's operations. X's compensation is primarily in the form of a fixed salary. In addition, X is eligible to receive an incentive award based on revenues of the radiology department. X's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. X is not related to any other disqualified person of U. X does not serve on U's governing body or as an officer of U. Although U participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act), X does not have a material financial interest in that organization. X does not receive compensation primarily based on revenues derived from activities of U that X controls. X does not participate in any management decisions affecting either U as a whole or a discrete segment of U that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, X does not have substantial influence over the affairs of U, and therefore X is not a disqualified person with respect to U.

Example 11. W is a cardiologist and head of the cardiology department of the same hospital U described in *Example 10.* The cardiology department is a major source of patients admitted to U and consequently represents a substantial portion of U's income, as compared to U as a whole. W does not serve on U's governing board or as an officer of U. W does not have a material financial interest in the provider-sponsored organization (as defined in section 1855(e) of the Social Security Act) in which U participates. W receives a salary and retirement and welfare benefits fixed by a three-year renewable employment contract with U. W's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. As department head, W manages the cardiology department and has authority to allocate the budget for that department, which includes authority to distribute incentive bonuses among cardiologists according to criteria that W has authority to set. W's management of a discrete segment of U that represents a substantial portion of its income and activities (as compared to U as a whole) places W in a position to exercise substantial influence over the affairs of U. Under these facts and circumstances, W is a disqualified person with respect to U.

Example 12. M is a museum that is an applicable tax-exempt organization for purposes of section 4958. D provides accounting services and tax advice to M as a contractor in return for a fee. D has no other relationship with M and is not related to any disqualified person of M. D does not provide professional advice with respect to any transaction from which D might economically benefit either directly or indirectly (aside from fees received for the professional advice rendered). Because D's sole relationship to M is providing professional advice (without having decision-making authority) with respect to transactions from which D will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered), under these facts and circumstances, D is not a disqualified person with respect to M.

Example 13. F is a repertory theater company that is an applicable tax-exempt organization for purposes of section 4958. F holds a fund-raising campaign to pay for the construction of a new theater. J is a regular subscriber to F's productions who has made modest gifts to F in the past. J has no relationship to F other than as a subscriber and contributor. F solicits contributions as part of a broad public campaign intended to attract a large number of donors, including a substantial number of donors making large gifts. In its solicitations for contributions, F promises to invite all contributors giving $*z* or more to a special opening production and party held at the new theater. These contributors are also given a special number to call in F's office to reserve tickets for performances, make ticket exchanges, and make other special arrangements for their convenience. J makes a contribution of $*z* to F, which makes J a substantial contributor within the meaning of section 507(d)(2)(A), taking into account only contributions received by F during its current and the four preceding taxable years. J receives the benefits described in F's solicitation. Because F offers the same benefit to all donors of $*z* or more, the preferential treatment that J receives does not indicate that J is in a position to exercise substantial influence over the affairs of the organization. Therefore, under these facts and circumstances, J is not a disqualified person with respect to F.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–4 Excess benefit transaction.

(a) *Definition of excess benefit transaction*—(1) *In general.* An *excess benefit transaction* means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. Subject to the limitations of paragraph (c) of this section (relating to the treatment of economic benefits as compensation for the performance of services), to determine whether an excess benefit transaction has occurred, all consideration and benefits (except disregarded benefits described in paragraph (a)(4) of this section) exchanged between a disqualified person and the applicable tax-exempt organization and all entities the organization controls (within the meaning of paragraph (a)(2)(ii)(B) of this section) are taken into account. For example, in determining the reasonableness of compensation that is paid (or vests, or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. The rules of this section apply to all transactions with disqualified persons, regardless of whether the amount of the benefit provided is determined, in whole or in part, by the revenues of one or more activities of the organization. For rules regarding valuation standards, see paragraph (b) of this section. For the requirement that an applicable tax-exempt organization clearly indicate its intent to treat a benefit as compensation for services when paid, see paragraph (c) of this section.

(2) *Economic benefit provided indirectly*—(i) *In general.* A transaction that would be an excess benefit transaction if the applicable tax-exempt organization engaged in it directly with a disqualified person is likewise an excess benefit transaction when it is accomplished indirectly. An applicable tax-exempt organization may provide an excess benefit indirectly to a disqualified person through a controlled entity or through an intermediary, as described in paragraphs (a)(2)(ii) and (iii) of this section, respectively.

(ii) *Through a controlled entity*—(A) *In general.* An applicable tax-exempt organization may provide an excess benefit indirectly through the use of one or more entities it controls. For purposes of section 4958, economic benefits provided by a controlled entity will be treated as provided by the applicable tax-exempt organization.

(B) *Definition of control*—(*1*) *In general.* For purposes of this paragraph, *control* by an applicable tax-exempt organization means—

(*i*) In the case of a stock corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation;

(*ii*) In the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in the partnership;

(*iii*) In the case of a nonstock organization (*i.e.*, an entity in which no person holds a proprietary interest), that at least 50 percent of the directors or trustees of the organization are either representatives (including trustees, directors, agents, or employees) of, or directly or indirectly controlled by, an applicable tax-exempt organization; or

(*iv*) In the case of any other entity, ownership of more than 50 percent of the beneficial interest in the entity.

(*2*) *Constructive ownership.* Section 318 (relating to constructive ownership of stock) shall apply for purposes of determining ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity.

(iii) *Through an intermediary.* An applicable tax-exempt organization may provide an excess benefit indirectly through an intermediary. An intermediary is any person (including an individual or a taxable or tax-exempt entity) who participates in a transaction with one or more disqualified persons of an applicable tax-exempt organization. For purposes of section 4958, economic benefits provided by an intermediary will be treated as provided by the applicable tax-exempt organization when—

(A) An applicable tax-exempt organization provides an economic benefit to an intermediary; and

(B) In connection with the receipt of the benefit by the intermediary—

(*1*) There is evidence of an oral or written agreement or understanding that the intermediary will provide economic benefits to or for the use of a disqualified person; or

(*2*) The intermediary provides economic benefits to or for the use of a disqualified person without a significant business purpose or exempt purpose of its own.

(iv) *Examples.* The following examples illustrate when economic benefits are provided indirectly under the rules of this paragraph (a)(2):

Example 1. K is an applicable tax-exempt organization for purposes of section 4958. L is a wholly-owned taxable subsidiary of K. J is employed by K, and is a disqualified person with respect to K. K pays J an annual salary of $*12m,* and reports that amount as compensation during calendar year 2001. Although J only performed services for K for nine months of 2001, J performed equivalent services for L during the remaining three months of 2001. Taking into account all of the economic benefits K provided to J, and all of the services J performed for K and L, $*12m* does not exceed the fair market value of the services J performed for K and L during 2001. Therefore, under these facts, K does not provide an excess benefit to J directly or indirectly.

Example 2. F is an applicable tax-exempt organization for purposes of section 4958. D is an entity controlled by F within the meaning of paragraph (a)(2)(ii)(B) of this section. T is the chief executive officer (CEO) of F. As CEO, T is responsible for overseeing the activities of F. T's duties as CEO make him a disqualified person with respect to F. T's compensation package with F represents the maximum reasonable compensation for T's services as CEO. Thus, any additional economic benefits that F provides to T without T providing additional consideration constitute an excess benefit. D contracts with T to provide enumerated consulting services to D. However, the contract does not require T to perform any additional services for D that T is not already obligated to perform as F's chief executive officer. Therefore, any payment to T pursuant to the consulting contract with D represents an indirect excess benefit that F provides through a controlled entity, even if F, D, or T treats the additional payment to T as compensation.

Example 3. P is an applicable tax-exempt organization for purposes of section 4958. S is a taxable entity controlled by P within the meaning of paragraph (a)(2)(ii)(B) of this section. V is the chief executive officer of S, for which S pays V $*w* in salary and benefits. V also serves as a voting member of P's governing body. Consequently, V is a disqualified person with respect to P. P provides V with $*x* representing compensation for the services V provides P as a member of its governing body. Although $*x* represents reasonable compensation for the services V provides directly to P as a member of its governing body, the total compensation of $*w* + $*x* exceeds reasonable compensation for the services V provides to P and S collectively. Therefore, the portion of total compensation that exceeds reasonable compensation is an excess benefit provided to V.

Example 4. G is an applicable tax-exempt organization for section 4958 purposes. F is a disqualified person who was last employed by G in a position of substantial influence three years ago. H is an entity engaged in scientific research and is unrelated to either F or G. G makes a grant to H to fund a research position. H subsequently advertises for qualified candidates for the research position. F is among several highly qualified candidates who apply for the research position. H hires F. There was no evidence of an oral or written agreement or understanding with G that H will use G's grant to provide economic benefits to or for the use of F. Although G provided economic benefits to H, and in connection with the receipt of such benefits, H will provide economic benefits to or for the use of F, H acted with a significant business purpose or exempt purpose of its own. Under these facts, G did not provide an economic benefit to F indirectly through the use of an intermediary.

(3) *Exception for fixed payments made pursuant to an initial contract*—(i) *In general.* Except as provided in paragraph (a)(3)(iv) of this section, section 4958 does not apply to any fixed payment made to a person pursuant to an initial contract.

(ii) *Fixed payment*—(A) *In general.* For purposes of paragraph (a)(3)(i) of this section, *fixed payment* means an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. A fixed formula may incorporate an amount that depends upon future specified events or contingencies, provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). A specified event or contingency may include the amount of revenues generated by (or other objective measure of) one or more activities of

the applicable tax-exempt organization. A fixed payment does not include any amount paid to a person under a reimbursement (or similar) arrangement where discretion is exercised by any person with respect to the amount of expenses incurred or reimbursed.

(B) *Special rules.* Amounts payable pursuant to a qualified pension, profit-sharing, or stock bonus plan under section 401(a), or pursuant to an employee benefit program that is subject to and satisfies coverage and nondiscrimination rules under the Internal Revenue Code (e.g., sections 127 and 137), other than nondiscrimination rules under section 9802, are treated as fixed payments for purposes of this section, regardless of the applicable tax-exempt organization's discretion with respect to the plan or program. The fact that a person contracting with an applicable tax-exempt organization is expressly granted the choice whether to accept or reject any economic benefit is disregarded in determining whether the benefit constitutes a fixed payment for purposes of this paragraph.

(iii) *Initial contract.* For purposes of paragraph (a)(3)(i) of this section, *initial contract* means a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the contract.

(iv) *Substantial performance required.* Paragraph (a)(3)(i) of this section does not apply to any fixed payment made pursuant to the initial contract during any taxable year of the person contracting with the applicable tax-exempt organization if the person fails to perform substantially the person's obligations under the initial contract during that year.

(v) *Treatment as a new contract.* A written binding contract that provides that the contract is terminable or subject to cancellation by the applicable tax-exempt organization (other than as a result of a lack of substantial performance by the disqualified person, as described in paragraph (a)(3)(iv) of this section) without the other party's consent and without substantial penalty to the organization is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective. Additionally, if the parties make a material change to a contract, it is treated as a new contract as of the date the material change is effective. A material change includes an extension or renewal of the contract (other than an extension or renewal that results from the person contracting with the applicable tax-exempt organization unilaterally exercising an option expressly granted by the contract), or a more than incidental change to any amount payable under the contract. The new contract is tested under paragraph (a)(3)(iii) of this section to determine whether it is an initial contract for purposes of this section.

(vi) *Evaluation of non-fixed payments.* Any payment that is not a fixed payment (within the meaning of paragraph (a)(3)(ii) of this section) is evaluated to determine whether it constitutes an excess benefit transaction under section 4958. In making this determination, all payments and consideration exchanged between the parties are taken into account, including any fixed payments made pursuant to an initial contract with respect to which section 4958 does not apply.

(vii) *Examples.* The following examples illustrate the rules governing fixed payments made pursuant to an initial contract. Unless otherwise stated, assume that the person contracting with the applicable tax-exempt organization has performed substantially the person's obligations under the contract with respect to the payment. The examples are as follows:

Example 1. T is an applicable tax-exempt organization for purposes of section 4958. On January 1, 2002, T hires S as its chief financial officer by entering into a five-year written employment contract with S. S was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the January 1, 2002, contract (initial contract). S's duties and responsibilities under the contract make S a disqualified person with respect to T (see § 53.4958–3(c)(3)). Under the initial contract, T agrees to pay S an annual salary of $200,000, payable in monthly installments. The contract provides that, beginning in 2003, S's annual salary will be adjusted by the increase in the Consumer Price Index (CPI) for the prior year. Section 4958 does not apply because S's compensation under the contract is

a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. Thus, for section 4958 purposes, it is unnecessary to evaluate whether any portion of the compensation paid to S pursuant to the initial contract is an excess benefit transaction.

Example 2. The facts are the same as in *Example 1,* except that the initial contract provides that, in addition to a base salary of $200,000, T may pay S an annual performance-based bonus. The contract provides that T's governing body will determine the amount of the annual bonus as of the end of each year during the term of the contract, based on the board's evaluation of S's performance, but the bonus cannot exceed $100,000 per year. Unlike the base salary portion of S's compensation, the bonus portion of S's compensation is not a fixed payment pursuant to an initial contract, because the governing body has discretion over the amount, if any, of the bonus payment. Section 4958 does not apply to payment of the $200,000 base salary (as adjusted for inflation), because it is a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. By contrast, the annual bonuses that may be paid to S under the initial contract are not protected by the initial contract exception. Therefore, each bonus payment will be evaluated under section 4958, taking into account all payments and consideration exchanged between the parties.

Example 3. The facts are the same as in *Example 1,* except that in 2003, T changes its payroll system, such that T makes biweekly, rather than monthly, salary payments to its employees. Beginning in 2003, T also grants its employees an additional two days of paid vacation each year. Neither change is a material change to S's initial contract within the meaning of paragraph (a)(3)(v) of this section. Therefore, section 4958 does not apply to the base salary payments to S due to the initial contract exception.

Example 4. The facts are the same as in *Example 1,* except that on January 1, 2003, S becomes the chief executive officer of T and a new chief financial officer is hired. At the same time, T's board of directors approves an increase in S's annual base salary from $200,000 to $240,000, effective on that day. These changes in S's employment relationship constitute material changes of the initial contract within the meaning of paragraph (a)(3)(v) of this section. As a result, S is treated as entering into a new contract with T on January 1, 2003, at which time S is a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3. T's payments to S made pursuant to the new contract will be evaluated under section 4958, taking into account all payments and consideration exchanged between the parties.

Example 5. J is a performing arts organization and an applicable tax-exempt organization for purposes of section 4958. J hires W to become the chief executive officer of J. W was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the employment contract with J. As a result of this employment contract, W's duties and responsibilities make W a disqualified person with respect to J (see § 53.4958–3(c)(2)). Under the contract, J will pay W $*x* (a specified amount) plus a bonus equal to 2 percent of the total season subscription sales that exceed $*100z*. The $*x* base salary is a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. The bonus payment is also a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section, because no person exercises discretion when calculating the amount of the bonus payment or deciding whether the bonus will be paid. Therefore, section 4958 does not apply to any of J's payments to W pursuant to the employment contract due to the initial contract exception.

Example 6. Hospital B is an applicable tax-exempt organization for purposes of section 4958. Hospital B hires E as its chief operating officer. E was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the employment contract with Hospital B. As a result of this employment contract, E's duties and responsibilities make E a disqualified person with respect to Hospital B (see § 53.4958–3(c)(2)). E's initial employment contract provides that E will have authority to enter into hospital management arrangements on behalf of Hospital B. In E's personal capacity, E owns more than 35 percent of the combined voting power of Company X. Consequently, at the time E becomes a disqualified person with respect to B, Company X also becomes a disqualified person with respect to B (see § 53.4958–3(b)(2)(i)(A)). E, acting on behalf of Hospital B as chief operating officer, enters into a contract with Company X under which Company X will provide billing and collection services to Hospital B. The initial contract exception of paragraph (a)(3)(i) of this section does not apply to the billing and collection services contract, because at the time that this contractual arrangement was entered into, Company X was a disqualified person with respect to Hospital B. Although E's employment contract (which is an initial contract) authorizes E to enter into hospital management arrangements on behalf of Hospital B, the payments made to Company X are not made pursuant to E's employment contract, but rather are made by Hospital B pursuant to a separate contractual arrangement with Company X.

Therefore, even if payments made to Company X under the billing and collection services contract are fixed payments (within the meaning of paragraph (a)(3)(ii) of this section), section 4958 nonetheless applies to payments made by Hospital B to Company X because the billing and collection services contract itself does not constitute an initial contract under paragraph (a)(3)(iii) of this section. Accordingly, all payments made to Company X under the billing and collection services contract will be evaluated under section 4958.

Example 7. Hospital C, an applicable tax-exempt organization, enters into a contract with Company Y, under which Company Y will provide a wide range of hospital management services to Hospital C. Upon entering into this contractual arrangement, Company Y becomes a disqualified person with respect to Hospital C. The contract provides that Hospital C will pay Company Y a management fee of *x* percent of adjusted gross revenue (*i.e.*, gross revenue increased by the cost of charity care provided to indigents) annually for a five-year period. The management services contract specifies the cost accounting system and the standards for *indigents* to be used in calculating the cost of charity care. The cost accounting system objectively defines the direct and indirect costs of all health care goods and services provided as charity care. Because Company Y was not a disqualified person with respect to Hospital C immediately before entering into the management services contract, that contract is an initial contract within the meaning of paragraph (a)(3)(iii) of this section. The annual management fee paid to Company Y is determined by a fixed formula specified in the contract, and is therefore a fixed payment within the meaning of paragraph (a)(3)(ii) of this section. Accordingly, section 4958 does not apply to the annual management fee due to the initial contract exception.

Example 8. The facts are the same as in *Example 7*, except that the management services contract also provides that Hospital C will reimburse Company Y on a monthly basis for certain expenses incurred by Company Y that are attributable to management services provided to Hospital C (e.g., legal fees and travel expenses). Although the management fee itself is a fixed payment not subject to section 4958, the reimbursement payments that Hospital C makes to Company Y for the various expenses covered by the contract are not fixed payments within the meaning of paragraph (a)(3)(ii) of this section, because Company Y exercises discretion with respect to the amount of expenses incurred. Therefore, any reimbursement payments that Hospital C pays pursuant to the contract will be evaluated under section 4958.

Example 9. X, an applicable tax-exempt organization for purposes of section 4958, hires C to conduct scientific research. On January 1, 2003, C enters into a three-year written employment contract with X (initial contract). Under the terms of the contract, C is required to work full-time at X's laboratory for a fixed annual salary of $90,000. Immediately prior to entering into the employment contract, C was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3, nor did C become a disqualified person pursuant to the initial contract. However, two years after joining X, C marries D, who is the child of X's president. As D's spouse, C is a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 with respect to X. Nonetheless, section 4958 does not apply to X's salary payments to C due to the initial contract exception.

Example 10. The facts are the same as in *Example 9*, except that the initial contract included a below-market loan provision under which C has the unilateral right to borrow up to a specified dollar amount from X at a specified interest rate for a specified term. After C's marriage to D, C borrows money from X to purchase a home under the terms of the initial contract. Section 4958 does not apply to X's loan to C due to the initial contract exception.

Example 11. The facts are the same as in *Example 9*, except that after C's marriage to D, C works only sporadically at the laboratory, and performs no other services for X. Notwithstanding that C fails to perform substantially C's obligations under the initial contract, X does not exercise its right to terminate the initial contract for nonperformance and continues to pay full salary to C. Pursuant to paragraph (a)(3)(iv) of this section, the initial contract exception does not apply to any payments made pursuant to the initial contract during any taxable year of C in which C fails to perform substantially C's obligations under the initial contract.

(4) *Certain economic benefits disregarded for purposes of section 4958.* The following economic benefits are disregarded for purposes of section 4958—

(i) *Nontaxable fringe benefits.* An economic benefit that is excluded from income under section 132, except any liability insurance premium, payment, or reimbursement that must be taken into account under paragraph (b)(1)(ii)(B)(*2*) of this section;

(ii) *Expense reimbursement payments pursuant to accountable plans.* Amounts paid under reimbursement arrangements that meet the requirements of § 1.62–2(c) of this chapter;

(iii) *Certain economic benefits provided to a volunteer for the organization.* An economic benefit provided to a volunteer for the organization if the benefit

is provided to the general public in exchange for a membership fee or contribution of $75 or less per year;

(iv) *Certain economic benefits provided to a member of, or donor to, the organization*. An economic benefit provided to a member of an organization solely on account of the payment of a membership fee, or to a donor solely on account of a contribution for which a deduction is allowable under section 170 (charitable contribution), regardless of whether the donor is eligible to claim the deduction, if—

(A) Any non-disqualified person paying a membership fee or making a charitable contribution above a specified amount to the organization is given the option of receiving substantially the same economic benefit; and

(B) The disqualified person and a significant number of non-disqualified persons make a payment or charitable contribution of at least the specified amount;

(v) *Economic benefits provided to a charitable beneficiary*. An economic benefit provided to a person solely because the person is a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose; and

(vi) *Certain economic benefits provided to a governmental unit*. Any transfer of an economic benefit to or for the use of a governmental unit defined in section 170(c)(1), if the transfer is for exclusively public purposes.

(5) *Exception for certain payments made pursuant to an exemption granted by the Department of Labor under ERISA*. Section 4958 does not apply to any payment made pursuant to, and in accordance with, a final individual prohibited transaction exemption issued by the Department of Labor under section 408(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 854) (ERISA) with respect to a transaction involving a plan (as defined in section 3(3) of ERISA) that is an applicable tax exempt organization.

(b) *Valuation standards*—(1) *In general*. This section provides rules for determining the value of economic benefits for purposes of section 4958.

(i) *Fair market value of property*. The value of property, including the right to use property, for purposes of section 4958 is the fair market value (*i.e.*, the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts).

(ii) *Reasonable compensation*—(A) *In general*. The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (*i.e.*, reasonable compensation). Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under paragraph (a)(4) of this section) provided to a person and the rate at which any deferred compensation accrues. The fact that a compensation arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. The fact that a State or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation for purposes of section 4958.

(B) *Items included in determining the value of compensation for purposes of determining reasonableness under section 4958*. Except for economic benefits that are disregarded for purposes of section 4958 under paragraph (a)(4) of this section, compensation for purposes of determining reasonableness under section 4958 includes all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services. These benefits include, but are not limited to—

(*1*) All forms of cash and noncash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation described in § 53.4958–1(e)(2);

(*2*) Unless excludable from income as a *de minimis* fringe benefit pursuant to section 132(a)(4), the payment of liability insurance premiums for, or the payment or reimbursement by the organization of—

(*i*) Any penalty, tax, or expense of correction owed under section 4958;

(*ii*) Any expense not reasonably incurred by the person in connection with a civil judicial or civil administrative proceeding arising out of the person's performance of services on behalf of the applicable tax-exempt organization; or

(*iii*) Any expense resulting from an act or failure to act with respect to which the person has acted willfully and without reasonable cause; and

(*3*) All other compensatory benefits, whether or not included in gross income for income tax purposes, including payments to welfare benefit plans, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and nontaxable fringe benefits (other than fringe benefits described in section 132), including expense allowances or reimbursements (other than expense reimbursements pursuant to an accountable plan that meets the requirements of § 1.62–2(c)), and the economic benefit of a below-market loan (within the meaning of section 7872(e)(1)). (For this purpose, the economic benefit of a below-market loan is the amount deemed transferred to the disqualified person under section 7872(a) or (b), regardless of whether section 7872 otherwise applies to the loan).

(C) *Inclusion in compensation for reasonableness determination does not govern income tax treatment*. The determination of whether any item listed in paragraph (b)(1)(ii)(B) of this section is included in the disqualified person's gross income for income tax purposes is made on the basis of the provisions of chapter 1 of Subtitle A of the Internal Revenue Code, without regard to whether the item is taken into account for purposes of determining reasonableness of compensation under section 4958.

(2) *Timing of reasonableness determination*—(i) *In general*. The facts and circumstances to be taken into consideration in determining reasonableness of a fixed payment (within the meaning of paragraph (a)(3)(ii) of this section) are those existing on the date the parties enter into the contract pursuant to which the payment is made. However, in the event of substantial non-performance, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In the case of any payment that is not a fixed payment under a contract, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In no event shall circumstances existing at the date when the payment is questioned be considered in making a determination of the reasonableness of the payment. These general timing rules also apply to property subject to a substantial risk of forfeiture. Therefore, if the property subject to a substantial risk of forfeiture satisfies the definition of fixed payment (within the meaning of paragraph (a)(3)(ii) of this section), reasonableness is determined at the time the parties enter into the contract providing for the transfer of the property. If the property is not a fixed payment, then reasonableness is determined based on all facts and circumstances up to and including circumstances as of the date of payment.

(ii) *Treatment as a new contract*. For purposes of paragraph (b)(2)(i) of this section, a written binding contract that provides that the contract is terminable or subject to cancellation by the applicable tax-exempt organization without the other party's consent and without substantial penalty to the organization is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective. Additionally, if the parties make a material change to a contract (within the meaning of paragraph (a)(3)(v) of this section), it is treated as a new contract as of the date the material change is effective.

(iii) *Examples*. The following examples illustrate the timing of the reasonableness determination under the rules of this paragraph (b)(2):

Example 1. G is an applicable tax-exempt organization for purposes of section 4958. H is an employee of G and a disqualified person with respect to G. H's new multi-year employment contract provides for payment of a salary and provision of specific benefits pursuant to a qualified pension plan under section 401(a) and an accident and health plan that meets the requirements of section

105(h)(2). The contract provides that H's salary will be adjusted by the increase in the Consumer Price Index (CPI) for the prior year. The contributions G makes to the qualified pension plan are equal to the maximum amount G is permitted to contribute under the rules applicable to qualified plans. Under these facts, all items comprising H's total compensation are treated as fixed payments within the meaning of paragraph (a)(3)(ii) of this section. Therefore, the reasonableness of H's compensation is determined based on the circumstances existing at the time G and H enter into the employment contract.

Example 2. The facts are the same as in *Example 1*, except that the multi-year employment contract provides, in addition, that G will transfer title to a car to H under the condition that if H fails to complete *x* years of service with G, title to the car will be forfeited back to G. All relevant information about the type of car to be provided (including the make, model, and year) is included in the contract. Although ultimate vesting of title to the car is contingent on H continuing to work for G for *x* years, the amount of property to be vested (*i.e.*, the type of car) is specified in the contract, and no person exercises discretion regarding the type of property or whether H will retain title to the property at the time of vesting. Under these facts, the car is a fixed payment within the meaning of paragraph (a)(3)(ii) of this section. Therefore, the reasonableness of H's compensation, including the value of the car, is determined based on the circumstances existing at the time G and H enter into the employment contract.

Example 3. N is an applicable tax-exempt organization for purposes of section 4958. On January 2, N's governing body enters into a new one-year employment contract with K, its executive director, who is a disqualified person with respect to N. The contract provides that K will receive a specified amount of salary, contributions to a qualified pension plan under section 401(a), and other benefits pursuant to a section 125 cafeteria plan. In addition, the contract provides that N's governing body may, in its discretion, declare a bonus to be paid to K at any time during the year covered by the contract. K's salary and other specified benefits constitute fixed payments within the meaning of paragraph (a)(3)(ii) of this section. Therefore, the reasonableness of those economic benefits is determined on the date when the contract was made. However, because the bonus payment is not a fixed payment within the meaning of paragraph (a)(3)(ii) of this section, the determination of whether any bonus awarded to N is reasonable must be made based on all facts and circumstances (including all payments and consideration exchanged between the parties), up to and including circumstances as of the date of payment of the bonus.

(c) *Establishing intent to treat economic benefit as consideration for the performance of services*—(1) *In general*. An economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. Except as provided in paragraph (c)(2) of this section, an applicable tax-exempt organization (or entity controlled by an applicable tax-exempt organization, within the meaning of paragraph (a)(2)(ii)(B) of this section) is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provides written substantiation that is contemporaneous with the transfer of the economic benefit at issue. If an organization fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction. In no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services.

(2) *Nontaxable benefits*. For purposes of section 4958(c)(1)(A) and this section, an applicable tax-exempt organization is not required to indicate its intent to provide an economic benefit as compensation for services if the economic benefit is excluded from the disqualified person's gross income for income tax purposes on the basis of the provisions of chapter 1 of Subtitle A of the Internal Revenue Code. Examples of these benefits include, but are not limited to, employer-provided health benefits and contributions to a qualified pension, profit-sharing, or stock bonus plan under section 401(a), and benefits described in sections 127 and 137. However, except for economic benefits that are disregarded for purposes of section 4958 under paragraph (a)(4) of this section, all compensatory benefits (regardless of the Federal income tax treatment) provided by an organization in exchange for the performance of

services are taken into account in determining the reasonableness of a person's compensation for purposes of section 4958.

(3) *Contemporaneous substantiation*—(i) *Reporting of benefit*—(A) *In general*. An applicable tax-exempt organization provides contemporaneous written substantiation of its intent to provide an economic benefit as compensation if—

(*1*) The organization reports the economic benefit as compensation on an original Federal tax information return with respect to the payment (e.g., Form W-2, ''Wage and Tax Statement'', or Form 1099, ''Miscellaneous Income'') or with respect to the organization (e.g., Form 990, ''Return of Organization Exempt From Income Tax''), or on an amended Federal tax information return filed prior to the commencement of an Internal Revenue Service examination of the applicable tax-exempt organization or the disqualified person for the taxable year in which the transaction occurred (as determined under § 53.4958–1(e)); or

(*2*) The recipient disqualified person reports the benefit as income on the person's original Federal tax return (e.g., Form 1040, ''U.S. Individual Income Tax Return''), or on the person's amended Federal tax return filed prior to the earlier of the following dates—

(*i*) Commencement of an Internal Revenue Service examination described in paragraph (c)(3)(i)(A)(*1*) of this section; or

(*ii*) The first documentation in writing by the Internal Revenue Service of a potential excess benefit transaction involving either the applicable tax-exempt organization or the disqualified person.

(B) *Failure to report due to reasonable cause*. If an applicable tax-exempt organization's failure to report an economic benefit as required under the Internal Revenue Code is due to reasonable cause (within the meaning of § 301.6724–1 of this chapter), then the organization will be treated as having clearly indicated its intent to provide an economic benefit as compensation for services. To show that its failure to report an economic benefit that should have been reported on an information return was due to reasonable cause, an applicable tax-exempt organization must establish that there were significant mitigating factors with respect to its failure to report (as described in § 301.6724–1(b) of this chapter), or the failure arose from events beyond the organization's control (as described in § 301.6724–1(c) of this chapter), and that the organization acted in a responsible manner both before and after the failure occurred (as described in § 301.6724–1(d) of this chapter).

(ii) *Other written contemporaneous evidence*. In addition, other written contemporaneous evidence may be used to demonstrate that the appropriate decision-making body or an officer authorized to approve compensation approved a transfer as compensation for services in accordance with established procedures, including but not limited to—

(A) An approved written employment contract executed on or before the date of the transfer;

(B) Documentation satisfying the requirements of § 53.4958–6(a)(3) indicating that an authorized body approved the transfer as compensation for services on or before the date of the transfer; or

(C) Written evidence that was in existence on or before the due date of the applicable Federal tax return described in paragraph (c)(3)(i)(A)(*1*) or (*2*) of this section (including extensions but not amendments), of a reasonable belief by the applicable tax-exempt organization that a benefit was a nontaxable benefit as defined in paragraph (c)(2) of this section.

(4) *Examples*. The following examples illustrate the requirement that an organization contemporaneously substantiate its intent to provide an economic benefit as compensation for services, as defined in paragraph (c) of this section:

Example 1. G is an applicable tax-exempt organization for purposes of section 4958. G hires an individual contractor, P, who is also the child of a disqualified person of G, to design a computer program for it. G executes a contract with P for that purpose in accordance with G's established procedures, and pays P $1,000 during the year pursuant to the contract. Before January 31 of the next year, G reports the full amount paid to P under the contract on a Form 1099 filed with the Internal Revenue Service. G will be treated as providing contemporaneous written substantiation of its intent to provide the $1,000

paid to P as compensation for the services P performed under the contract by virtue of either the Form 1099 filed with the Internal Revenue Service reporting the amount, or by virtue of the written contract executed between G and P.

Example 2. G is an applicable tax-exempt organization for purposes of section 4958. D is the chief operating officer of G, and a disqualified person with respect to G. D receives a bonus at the end of the year. G's accounting department determines that the bonus is to be reported on D's Form W-2. Due to events beyond G's control, the bonus is not reflected on D's Form W-2. As a result, D fails to report the bonus on D's individual income tax return. G acts to amend Forms W-2 affected as soon as G is made aware of the error during an Internal Revenue Service examination. G's failure to report the bonus on an information return issued to D arose from events beyond G's control, and G acted in a responsible manner both before and after the failure occurred. Thus, because G had reasonable cause (within the meaning § 301.6724–1 of this chapter) for failing to report D's bonus, G will be treated as providing contemporaneous written substantiation of its intent to provide the bonus as compensation for services when paid.

Example 3. H is an applicable tax-exempt organization and J is a disqualified person with respect to H. J's written employment agreement provides for a fixed salary of $*y*. J's duties include soliciting funds for various programs of H. H raises a large portion of its funds in a major metropolitan area. Accordingly, H maintains an apartment there in order to provide a place to entertain potential donors. H makes the apartment available exclusively to J to assist in the fundraising. J's written employment contract does not mention the use of the apartment. H obtains the written opinion of a benefits compensation expert that the rental value of the apartment is not includable in J's income by reason of section 119, based on the expectation that the apartment will be used for fundraising activities. Consequently, H does not report the rental value of the apartment on J's Form W-2, which otherwise correctly reports J's taxable compensation. J does not report the rental value of the apartment on J's individual Form 1040. Later, the Internal Revenue Service correctly determines that the requirements of section 119 were not satisfied. Because of the written expert opinion, H has written evidence of its reasonable belief that use of the apartment was a nontaxable benefit as defined in paragraph (c)(2) of this section. That evidence was in existence on or before the due date of the applicable Federal tax return. Therefore, H has demonstrated its intent to treat the use of the apartment as compensation for services performed by J.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002; 67 FR 12472, Mar. 19, 2002]

§ 53.4958–5 Transaction in which the amount of the economic benefit is determined in whole or in part by the revenues of one or more activities of the organization. [Reserved]

§ 53.4958–6 Rebuttable presumption that a transaction is not an excess benefit transaction.

(a) *In general.* Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if the following conditions are satisfied—

(1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization within the meaning of § 53.4958–4(a)(2)(ii)(B)) composed entirely of individuals who do not have a conflict of interest (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section;

(2) The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, as described in paragraph (c)(2) of this section; and

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.

(b) *Rebutting the presumption.* If the three requirements of paragraph (a) of this section are satisfied, then the Internal Revenue Service may rebut the presumption that arises under paragraph (a) of this section only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. With respect to any fixed payment (within the meaning of § 53.4958–4(a)(3)(ii)), rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date

the parties enter into the contract pursuant to which the payment is made (except in the event of substantial nonperformance). With respect to all other payments (including non-fixed payments subject to a cap, as described in paragraph (d)(2) of this section), rebuttal evidence may include facts and circumstances up to and including the date of payment. See § 53.4958–4(b)(2)(i).

(c) *Requirements for invoking rebuttable presumption*—(1) *Approval by an authorized body*—(i) *In general.* An authorized body means—

(A) The governing body (*i.e.*, the board of directors, board of trustees, or equivalent controlling body) of the organization;

(B) A committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; or

(C) To the extent permitted under State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.

(ii) *Individuals not included on authorized body.* For purposes of determining whether the requirements of paragraph (a) of this section have been met with respect to a specific compensation arrangement or property transfer, an individual is not included on the authorized body when it is reviewing a transaction if that individual meets with other members only to answer questions, and otherwise recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement or property transfer.

(iii) *Absence of conflict of interest.* A member of the authorized body does not have a conflict of interest with respect to a compensation arrangement or property transfer only if the member—

(A) Is not a disqualified person participating in or economically benefitting from the compensation arrangement or property transfer, and is not a member of the family of any such disqualified person, as described in section 4958(f)(4) or § 53.4958–3(b)(1);

(B) Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefitting from the compensation arrangement or property transfer;

(C) Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefitting from the compensation arrangement or property transfer;

(D) Has no material financial interest affected by the compensation arrangement or property transfer; and

(E) Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the member.

(2) *Appropriate data as to comparability*—(i) *In general.* An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, under the standards set forth in § 53.4958–4(b), the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value. In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred; and offers received as part of an open and competitive bidding process.

(ii) *Special rule for compensation paid by small organizations.* For organizations with annual gross receipts (including contributions) of less than $1

million reviewing compensation arrangements, the authorized body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. No inference is intended with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.

(iii) *Application of special rule for small organizations.* For purposes of determining whether the special rule for small organizations described in paragraph (c)(2)(ii) of this section applies, an organization may calculate its annual gross receipts based on an average of its gross receipts during the three prior taxable years. If any applicable tax-exempt organization is controlled by or controls another entity (as defined in § 53.4958–4(a)(2)(ii)(B)), the annual gross receipts of such organizations must be aggregated to determine applicability of the special rule stated in paragraph (c)(2)(ii) of this section.

(iv) *Examples.* The following examples illustrate the rules for appropriate data as to comparability for purposes of invoking the rebuttable presumption of reasonableness described in this section. In all examples, compensation refers to the aggregate value of all benefits provided in exchange for services. The examples are as follows:

Example 1. Z is a university that is an applicable tax-exempt organization for purposes of section 4958. Z is negotiating a new contract with Q, its president, because the old contract will expire at the end of the year. In setting Q's compensation for its president at $*600x* per annum, the executive committee of the Board of Trustees relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of $*100x* to $*700x*; this survey does not divide its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Although many members of the executive committee have significant business experience, none of the members has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to Z, and because no other information was presented, the executive committee's decision with respect to Q's compensation was not based upon appropriate data as to comparability.

Example 2. The facts are the same as *Example 1*, except that the national compensation survey divides the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of the number of students it serves and the amount of its revenues) and geographic area. The survey data shows that university presidents at institutions comparable to and in the same geographic area as Z receive annual compensation in the range of $*200x* to $*300x*. The executive committee of the Board of Trustees of Z relies on the survey data and its evaluation of Q's many years of service as a tenured professor and high-ranking university official at Z in setting Q's compensation at $*275x* annually. The data relied upon by the executive committee constitutes appropriate data as to comparability.

Example 3. X is a tax-exempt hospital that is an applicable tax-exempt organization for purposes of section 4958. Before renewing the contracts of X's chief executive officer and chief financial officer, X's governing board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues related to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of taxable and tax-exempt hospitals. The survey data are sorted by a number of different variables, including the size of the hospitals and the nature of the services they provide, the level of experience and specific responsibilities of the executives, and the composition of the annual compensation packages. The board members were provided with the survey results, a detailed written analysis comparing the hospital's executives to those covered by the survey, and an opportunity to ask questions of a member of the firm that prepared the survey. The survey, as prepared and presented to X's board, constitutes appropriate data as to comparability.

Example 4. The facts are the same as *Example 3,* except that one year later, X is negotiating a new contract with its chief executive officer. The governing board of X obtains information indicating that the relevant market conditions have not changed materially, and possesses no other information indicating that the results of the prior year's survey are no longer valid. Therefore, X may continue to rely on the independent compensation survey prepared for the prior year in setting annual compensation under the new contract.

Example 5. W is a local repertory theater and an applicable tax-exempt organization for purposes of section 4958. W has had annual gross receipts ranging from $400,000 to

$800,000 over its past three taxable years. In determining the next year's compensation for W's artistic director, the board of directors of W relies on data compiled from a telephone survey of three other unrelated performing arts organizations of similar size in similar communities. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in the telephone survey is appropriate data as to comparability.

(3) *Documentation*—(i) For a decision to be documented adequately, the written or electronic records of the authorized body must note—

(A) The terms of the transaction that was approved and the date it was approved;

(B) The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;

(C) The comparability data obtained and relied upon by the authorized body and how the data was obtained; and

(D) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

(ii) If the authorized body determines that reasonable compensation for a specific arrangement or fair market value in a specific property transfer is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination. For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken. Records must be reviewed and approved by the authorized body as reasonable, accurate and complete within a reasonable time period thereafter.

(d) *No presumption with respect to non-fixed payments until amounts are determined*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, in the case of a payment that is not a fixed payment (within the meaning of § 53.4958–4(a)(3)(ii)), the rebuttable presumption of this section arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption under paragraph (a) of this section subsequently are satisfied. See § 53.4958–4(b)(2)(i).

(2) *Special rule for certain non-fixed payments subject to a cap.* If the authorized body approves an employment contract with a disqualified person that includes a non-fixed payment (such as a discretionary bonus) subject to a specified cap, the authorized body may establish a rebuttable presumption with respect to the non-fixed payment at the time the employment contract is entered into if—

(i) Prior to approving the contract, the authorized body obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the particular disqualified person would represent reasonable compensation;

(ii) The maximum amount payable under the contract (taking into account both fixed and non-fixed payments) does not exceed the amount referred to in paragraph (d)(2)(i) of this section; and

(iii) The other requirements for the rebuttable presumption of reasonableness under paragraph (a) of this section are satisfied.

(e) *No inference from absence of presumption.* The fact that a transaction between an applicable tax-exempt organization and a disqualified person is not subject to the presumption described in this section neither creates any inference that the transaction is an excess benefit transaction, nor exempts or relieves any person from compliance with any Federal or state law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of any applicable tax-exempt organization.

(f) *Period of reliance on rebuttable presumption.* Except as provided in paragraph (d) of this section with respect to non-fixed payments, the rebuttable presumption applies to all payments made or transactions completed in accordance with a contract, provided that the provisions of paragraph (a) of

this section were met at the time the parties entered into the contract.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–7 Correction.

(a) *In general.* An excess benefit transaction is corrected by undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. Paragraph (b) of this section describes the acceptable forms of correction. Paragraph (c) of this section defines the correction amount. Paragraph (d) of this section describes correction where a contract has been partially performed. Paragraph (e) of this section describes correction where the applicable tax-exempt organization involved in the transaction has ceased to exist or is no longer tax-exempt. Paragraph (f) of this section provides examples illustrating correction.

(b) *Form of correction*—(1) *Cash or cash equivalents.* Except as provided in paragraphs (b)(3) and (4) of this section, a disqualified person corrects an excess benefit only by making a payment in cash or cash equivalents, excluding payment by a promissory note, to the applicable tax-exempt organization equal to the correction amount, as defined in paragraph (c) of this section.

(2) *Anti-abuse rule.* A disqualified person will not satisfy the requirements of paragraph (b)(1) of this section if the Commissioner determines that the disqualified person engaged in one or more transactions with the applicable tax-exempt organization to circumvent the requirements of this correction section, and as a result, the disqualified person effectively transferred property other than cash or cash equivalents.

(3) *Special rule relating to nonqualified deferred compensation.* If an excess benefit transaction results, in whole or in part, from the vesting (as described in § 53.4958–1(e)(2)) of benefits provided under a nonqualified deferred compensation plan, then, to the extent that such benefits have not yet been distributed to the disqualified person, the disqualified person may correct the portion of the excess benefit resulting from the undistributed deferred compensation by relinquishing any right to receive the excess portion of the undistributed deferred compensation (including any earnings thereon).

(4) *Return of specific property*—(i) *In general.* A disqualified person may, with the agreement of the applicable tax-exempt organization, make a payment by returning specific property previously transferred in the excess benefit transaction. In this case, the disqualified person is treated as making a payment equal to the lesser of—

(A) The fair market value of the property determined on the date the property is returned to the organization; or

(B) The fair market value of the property on the date the excess benefit transaction occurred.

(ii) *Payment not equal to correction amount.* If the payment described in paragraph (b)(4)(i) of this section is less than the correction amount (as described in paragraph (c) of this section), the disqualified person must make an additional cash payment to the organization equal to the difference. Conversely, if the payment described in paragraph (b)(4)(i) of this section exceeds the correction amount (as described in paragraph (c) of this section), the organization may make a cash payment to the disqualified person equal to the difference.

(iii) *Disqualified person may not participate in decision.* Any disqualified person who received an excess benefit from the excess benefit transaction may not participate in the applicable tax-exempt organization's decision whether to accept the return of specific property under paragraph (b)(4)(i) of this section.

(c) *Correction amount.* The correction amount with respect to an excess benefit transaction equals the sum of the excess benefit (as defined in § 53.4958–1(b)) and interest on the excess benefit. The amount of the interest charge for purposes of this section is determined by multiplying the excess benefit by an interest rate, compounded annually, for the period from the date the excess

benefit transaction occurred (as defined in § 53.4958–1(e)) to the date of correction. The interest rate used for this purpose must be a rate that equals or exceeds the applicable Federal rate (AFR), compounded annually, for the month in which the transaction occurred. The period from the date the excess benefit transaction occurred to the date of correction is used to determine whether the appropriate AFR is the Federal short-term rate, the Federal mid-term rate, or the Federal long-term rate. See section 1274(d)(1)(A).

(d) *Correction where contract has been partially performed.* If the excess benefit transaction arises under a contract that has been partially performed, termination of the contractual relationship between the organization and the disqualified person is not required in order to correct. However, the parties may need to modify the terms of any ongoing contract to avoid future excess benefit transactions.

(e) *Correction in the case of an applicable tax-exempt organization that has ceased to exist, or is no longer tax-exempt*—(1) *In general.* A disqualified person must correct an excess benefit transaction in accordance with this paragraph where the applicable tax-exempt organization that engaged in the transaction no longer exists or is no longer described in section 501(c)(3) or (4) and exempt from tax under section 501(a).

(2) *Section 501(c)(3) organizations.* In the case of an excess benefit transaction with a section 501(c)(3) applicable tax-exempt organization, the disqualified person must pay the correction amount, as defined in paragraph (c) of this section, to another organization described in section 501(c)(3) and exempt from tax under section 501(a) in accordance with the dissolution clause contained in the constitutive documents of the applicable tax-exempt organization involved in the excess benefit transaction, provided that—

(i) The organization receiving the correction amount is described in section 170(b)(1)(A) (other than in section 170(b)(1)(A)(vii) and (viii)) and has been in existence and so described for a continuous period of at least 60 calendar months ending on the correction date;

(ii) The disqualified person is not also a disqualified person (as defined in § 53.4958–3) with respect to the organization receiving the correction amount; and

(iii) The organization receiving the correction amount does not allow the disqualified person (or persons described in § 53.4958–3(b) with respect to that person) to make or recommend any grants or distributions by the organization.

(3) *Section 501(c)(4) organizations.* In the case of an excess benefit transaction with a section 501(c)(4) applicable tax-exempt organization, the disqualified person must pay the correction amount, as defined in paragraph (c) of this section, to a successor section 501(c)(4) organization or, if no tax-exempt successor, to any organization described in section 501(c)(3) or (4) and exempt from tax under section 501(a), provided that the requirements of paragraphs (e)(2)(i) through (iii) of this section are satisfied (except that the requirement that the organization receiving the correction amount is described in section 170(b)(1)(A) (other than in section 170(b)(1)(A)(vii) and (viii)) shall not apply if the organization is described in section 501(c)(4)).

(f) *Examples.* The following examples illustrate the principles of this section describing the requirements of correction:

Example 1. W is an applicable tax-exempt organization for purposes of section 4958. D is a disqualified person with respect to W. W employed D in 1999 and made payments totaling $*12t* to D as compensation throughout the taxable year. The fair market value of D's services in 1999 was $*7t*. Thus, D received excess compensation in the amount of $*5t*, the excess benefit for purposes of section 4958. In accordance with § 53.4958–1(e)(1), the excess benefit transaction with respect to the series of compensatory payments during 1999 is deemed to occur on December 31, 1999, the last day of D's taxable year. In order to correct the excess benefit transaction on June 30, 2002, D must pay W, in cash or cash equivalents, excluding payment with a promissory note, $*5t* (the excess benefit) plus interest on $*5t* for the period from the date the excess benefit transaction occurred to the date of correction (*i.e.*, December 31, 1999, to June 30, 2002). Because this period is not more than three years, the interest rate D must use to determine the interest on the excess benefit must equal or exceed the short-term AFR, compounded annually, for

December, 1999 (5.74%, compounded annually).

Example 2. X is an applicable tax-exempt organization for purposes of section 4958. B is a disqualified person with respect to X. On January 1, 2000, B paid X $*6v* for Property F. Property F had a fair market value of $*10v* on January 1, 2000. Thus, the sales transaction on that date provided an excess benefit to B in the amount of $*4v*. In order to correct the excess benefit on July 5, 2005, B pays X, in cash or cash equivalents, excluding payment with a promissory note, $*4v* (the excess benefit) plus interest on $*4v* for the period from the date the excess benefit transaction occurred to the date of correction (*i.e.*, January 1, 2000, to July 5, 2005). Because this period is over three but not over nine years, the interest rate B must use to determine the interest on the excess benefit must equal or exceed the mid-term AFR, compounded annually, for January, 2000 (6.21%, compounded annually).

Example 3. The facts are the same as in *Example 2,* except that B offers to return Property F. X agrees to accept the return of Property F, a decision in which B does not participate. Property F has declined in value since the date of the excess benefit transaction. On July 5, 2005, the property has a fair market value of $*9v*. For purposes of correction, B's return of Property F to X is treated as a payment of $*9v*, the fair market value of the property determined on the date the property is returned to the organization. If $*9v* is greater than the correction amount ($*4v* plus interest on $*4v* at a rate that equals or exceeds 6.21%, compounded annually, for the period from January 1, 2000, to July 5, 2005), then X may make a cash payment to B equal to the difference.

Example 4. The facts are the same as in *Example 3,* except that Property F has increased in value since January 1, 2000, the date the excess benefit transaction occurred, and on July 5, 2005, has a fair market value of $*13v*. For purposes of correction, B's return of Property F to X is treated as a payment of $*10v*, the fair market value of the property on the date the excess benefit transaction occurred. If $*10v* is greater than the correction amount ($*4v* plus interest on $*4v* at a rate that equals or exceeds 6.21%, compounded annually, for the period from January 1, 2000, to July 5, 2005), then X may make a cash payment to B equal to the difference.

Example 5. The facts are the same as in *Example 2.* Assume that the correction amount B paid X in cash on July 5, 2005, was $*5.58v*. On July 4, 2005, X loaned $*5.58v* to B, in exchange for a promissory note signed by B in the amount of $*5.58v*, payable with interest at a future date. These facts indicate that B engaged in the loan transaction to circumvent the requirement of this section that (except as provided in paragraph (b)(3) or (4) of this section), the correction amount must be paid only in cash or cash equivalents. As a result, the Commissioner may determine that B effectively transferred property other than cash or cash equivalents, and therefore did not satisfy the correction requirements of this section.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–8 Special rules.

(a) *Substantive requirements for exemption still apply.* Section 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or (4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. Thus, regardless of whether a particular transaction is subject to excise taxes under section 4958, existing principles and rules may be implicated, such as the limitation on private benefit. For example, transactions that are not subject to section 4958 because of the initial contract exception described in § 53.4958–4(a)(3) may, under certain circumstances, jeopardize the organization's tax-exempt status.

(b) *Interaction between section 4958 and section 7611 rules for church tax inquiries and examinations.* The procedures of section 7611 will be used in initiating and conducting any inquiry or examination into whether an excess benefit transaction has occurred between a church and a disqualified person. For purposes of this rule, the reasonable belief required to initiate a church tax inquiry is satisfied if there is a reasonable belief that a section 4958 tax is due from a disqualified person with respect to a transaction involving a church. See § 301.7611–1 Q&A 19 of this chapter.

(c) *Other substantiation requirements.* These regulations, in § 53.4958–4(c)(3), set forth specific substantiation rules. Compliance with the specific substantiation rules of that section does not relieve applicable tax-exempt organizations of other rules and requirements of the Internal Revenue Code, regulations, Revenue Rulings, and other guidance issued by the Internal Revenue Service (including the substantiation rules of sections 162 and 274, or § 1.6001–1(a) and (c) of this chapter).

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4961–1 Abatement of second tier taxes for correction within correction period.

If any taxable event is corrected during the correction period for the event, then any second tier tax imposed with respect to the event shall not be assessed. If the tax has been assessed, it shall be abated. If the tax has been collected, it shall be credited or refunded as an overpayment. For purposes of this section, the tax imposed includes interest, additions to the tax and additional amounts. For definitions of the terms *second tier tax*, *taxable event*, *correct*, and *correction period*, see § 53.4963–1.

§ 53.4961–2 Court proceedings to determine liability for second tier tax.

(a) *Introduction*. Under section 4961 (b) and (c), the period of limitations on collection may be suspended and assessment or collection of first or second tier tax may be prohibited during the pendency of administrative and judicial proceedings conducted to determine a taxpayer's liability for second tier tax. This section provides rules relating to the suspension of the limitations period and the prohibitions on assessment and collection. In addition, this section describes the administrative and judicial proceedings to which these rules apply.

(b) *Initial proceeding*—(1) *Defined*. For purposes of subpart K, an initial proceeding means a proceeding described in subparagraph (2) or (3).

(2) *Tax Court proceeding before assessment*. A proceeding is described in this subparagraph (2) if it is a proceeding with respect to the taxpayer's liability for second tier tax and is commenced in accordance with section 6213 (a).

(3) *Refund proceeding commenced before correction period ends*. A proceeding is described in this subparagraph (3) if it is a proceeding commenced under section 7422, in accordance with the provisions of § 53.4963–1(e) (4) and (5) (relating to prerequisites to extension of the correction period during certain refund proceedings), and with respect to the taxpayer's liability for second tier tax.

(c) *Supplemental proceeding*—(1) *Jurisdiction*. If a determination in an initial proceeding that a taxpayer is liable for a second tier tax has become final, the court in which the initial proceeding was commenced shall have jurisdiction to conduct any necessary supplemental proceeding to determine whether the taxable event was corrected during the correction period.

(2) *Time for beginning proceeding*. The time for beginning a supplemental proceeding begins on the day after a determination in an initial proceeding becomes final and ends on the 90th day after the last day of the correction period.

(d) *Restriction on assessment during Tax Court proceeding*. If a supplemental proceeding described in section 4961 (b) and § 53.4961–2(c) is commenced in the Tax Court, the provisions of the second and third sentences of section 6213(a) and the first and third sentences of § 301.6213–1(a)(2) apply with respect to a deficiency in second tier tax until the decision of the Tax Court in the supplemental proceeding is final.

(e) *Suspension of period of collection for second tier tax*—(1) *Scope*. Except as provided in subparagraph (6), this paragraph (e) applies to the second tier tax assessed with respect to a taxable event if a claim described in subparagraph (2) is filed.

(2) *Claim for refund*. A claim for refund is described in this subparagraph (2) if, no later than 90 days after the day on which the second tier tax is assessed with respect to a taxable event, the taxpayer—

(i) Pays the full amount of first tier tax for the taxable period, and

(ii) Files a claim for refund of the amount paid.

(3) *Collection prohibited*. No levy or proceeding in court for the collection of the second tier tax shall be made, begun, or prosecuted until the end of the collection prohibition period described in subparagraph (5). Notwithstanding section 7421(a), the collection by levy or proceeding may be enjoined during the collection prohibition period by a proceeding in the proper court.

(4) *Suspension of running of period of limitations on collection*. With respect to a second tier tax to which this paragraph (e) applies, the running of the period of limitations provided in section 6502 (relating to collection of tax by levy or by a proceeding in court) shall

be suspended for the collection prohibition period described in subparagraph (5).

(5) *Collection prohibition period.* The collection prohibition period begins on the day the second tier tax is assessed and ends on the latest of:

(i) The day a decision in a refund proceeding commenced before the 91st day after denial of the claim described in subparagraph (2) of this paragraph (including any supplemental proceeding under § 53.4961–2(c)) becomes final;

(ii) The 90th day after the claim referred to in subparagraph (2) is denied; or

(iii) The 90th day after the second tier tax is assessed.

(6) *Jeopardy collection.* If the Secretary makes a finding that the collection of the second tier tax is in jeopardy, nothing in this paragraph (e) shall prevent the immediate collection of such tax.

(f) *Finality*—(1) *Tax Court proceeding.* For purposes of this subpart K, section 7481 applies in determining when a decision in a Tax Court proceeding becomes final.

(2) *Refund proceeding.* For purposes of this subpart K, § 301.7422–1 applies in determining when a decision in a refund proceeding becomes final.

§ 53.4963–1 Definitions.

(a) *First tier tax.* For purposes of this subpart K, the term *first tier tax* means any tax imposed by subsection (a) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4958, 4971, or 4975. A first tier tax may also be referred to as an ''initial tax'' in parts 53 and 54.

(b) *Second tier tax.* For purposes of this subpart K, the term *second tier tax* means any tax imposed by subsection (b) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4958, 4971, or 4975. A second tier tax may also be referred to as an ''additional tax'' in parts 53 and 54.

(c) *Taxable event.* For purposes of this subpart K, the term *taxable event* means any act, or failure to act, giving rise to liability for tax under section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4958, 4971, or 4975.

(d) *Correct*—(1) *In general.* Except as provided in subparagraph (2), the term *correct* has the same meaning for purposes of this subpart K as in the section which imposes the second tier tax or the regulations thereunder.

(2) *Special rules.* The term *correct* means—

(i) For a second tier tax imposed by section 4942(b), reducing the amount of the undistributed income to zero,

(ii) For a second tier tax imposed by section 4943(b), reducing the amount of the excess business holdings to zero, and

(iii) For a second tier tax imposed by section 4944(b), removing the investment from jeopardy.

(e) *Correction period*—(1) *In general.* The correction period with respect to any taxable event shall begin with the date on which the taxable event occurs and shall end 90 days after the date of mailing of a notice of deficiency under section 6212 with respect to the second tier tax imposed with respect to the taxable event.

(2) *Extensions of correction period.* The correction period referred to in subparagraph (1) of this paragraph shall be extended by any period in which a deficiency cannot be assessed under section 6213(a). In addition, the correction period referred to in subparagraph (1) of this paragraph (e) shall be extended in accordance with subparagraph (3), (4), and (5) of this paragraph except that subparagraph (4), or (5) shall not operate to extend a correction period with respect to which a taxpayer has filed a petition with the United States Tax Court for redetermination of a deficiency within the time prescribed by section 6213(a).

(3) *Extensions by Commissioner.* The correction period referred to in subparagraph (1) of this paragraph may be extended by any period which the Commissioner determines is reasonable and necessary to bring about correction (including, for taxes imposed by section 4975, equitable relief sought by the Secretary of Labor) of the taxable event. The Commissioner ordinarily will not extend the correction period unless the following factors are present.

(i) The taxpayer on whom the second tier tax is imposed, the Secretary of Labor (for taxes imposed by section 4975), or an appropriate State officer

(as defined in section 6104(c)(2)) is actively seeking in good faith to correct the taxable event;

(ii) Adequate corrective action cannot reasonably be expected to result during the unextended correction period;

(iii) For taxes imposed by section 4975, the Secretary of Labor requests the extension because subdivision (ii) applies; and

(iv) For taxes imposed by chapter 42 (other than taxes imposed by section 4940), the taxable event appears to have been an isolated occurrence so that it appears unlikely that similar taxable events will occur in the future.

(4) *Extension for payment of first tier tax.* If, within the unexpected correction period, the taxpayer pays the full amount of the first tier tax imposed with respect to the taxable event the Commissioner shall extend the correction period to the later of—

(i) Ninety days after the payment of the first tier tax, or

(ii) The last day of the correction period determined without regard to this paragraph.

(5) *Extensions for filing claim for refund or refund suit.* If prior to the expiration of the correction period (including extensions) a claim for refund is filed with respect to payment of the full amount of the first tier tax imposed with respect to the taxable event, the Commissioner shall extend the correction period during the pendency of the claim plus an additional 90 days. If within that time a suit or proceeding referred to in section 7422(g) with respect to the claim is filed, the Commissioner shall extend the correction period until the determination in the suit for refund (determined without regard to a supplemental proceeding under section 4861(b)) is final, determined under § 301.7422–2(a).

(6) *End of correction period if waiver accepted.* If the notice of deficiency referred to in paragraph (1) is not mailed because there is a waiver of the restrictions on assessment and collection of the deficiency or because the deficiency is paid, the correction period will end with the end of the collection prohibition period described in § 53.4961–2(e)(5).

(7) *Date on which taxable event occurs.* For purposes of subparagraph (1), the taxable event shall be treated as occurring—

(i) Under section 4942, on the first day of the taxable year for which there is undistributed income,

(ii) Under section 4943, on the first day on which there are excess business holdings,

(iii) Under section 4971, on the last day of the plan year in which there is an accumulated funding deficiency, and

(iv) In all other cases, the date on which the event occurred.

(f) *Effective date.* The provisions of this subpart K are effective with respect to second tier taxes assessed after December 24, 1980. The preceding sentence shall not be construed to permit the assessment of a tax in a case to which, on December 24, 1980, the doctrine of res judicata applied.

[T.D. 8084, 51 FR 16303, May 2, 1986; 51 FR 17732, May 15, 1986, as amended by T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 8920, 66 FR 2171, Jan. 10, 2001]

Subpart L—Procedure and Administration

SOURCE: T.D. 7368, 40 FR 29843, July 16, 1975, unless otherwise noted. Redesignated by T.D. 8084, 51 FR 16303, May 2, 1986.

§ 53.6001–1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* Any person subject to tax under Chapter 42, Subtitle D, of the Code shall keep such complete and detailed records as are sufficient to enable the district director to determine accurately the amount of liability under Chapter 42.

(b) *Notice by district director requiring returns, statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under Chapter 42.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by

authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§ 53.6011–1 General requirement of return, statement or list.

(a) Every private foundation liable for tax under section 4940 or 4948(a) shall file an annual return with respect to such tax on the form prescribed by the Internal Revenue Service for such purpose and shall include therein the information required by such form and the instructions issued with respect thereto.

(b) Every person liable for tax imposed by sections 4941(a), 4942(a), 4943(a), 4944(a), 4945(a), 4955(a), 4958(a), or 4965(a), and every private foundation and every trust described in section 4947(a)(2) which has engaged in an act of self-dealing (as defined in section 4941(d)) (other than an act giving rise to no tax under section 4941(a)) shall file an annual return on Form 4720 and shall include therein the information required by such form and the instructions issued with respect thereto. In the case of any tax imposed by sections 4941(a), 4942(a), 4943(a), and 4944(a), the annual return shall be filed with respect to each act (or failure to act) for each year (or part thereof) in the taxable period (as defined in sections 4941 (e)(1), 4942(j)(1), 4943(d)(2), and 4944(e)(1)). In the case of a tax imposed by section 4945(a), 4955(a), 4958(a), or 4965(a), the annual return shall be filed with respect to each act for the year in which such act giving rise to liability occurred.

(c) If a Form 4720 is filed by a private foundation or trust described in section 4947(a)(2) with respect to a transaction to which other persons are required to file under paragraph (b) of this section, such persons may by their signature designate such organization's Form 4720 (to the extent applicable) as their return for purposes of compliance with such paragraph. However, this paragraph shall not apply to a person whose taxable year is other than the taxable year of the foundation or trust.

(d) For taxable years ending on or after December 31, 1975, every trust described in section 4947(a)(2) which is subject to any of the provisions of Chapter 42 as if it were a private foundation shall file an annual return on Form 5227. For taxable years beginning after December 31, 1980, every trust described in section 4947(a)(1) which is a private foundation shall file an annual return on Form 990–PF.

(e) For taxable years beginning after December 31, 1977, every person liable for tax under section 4951, 4952, or 4953 (relating to taxes on self-dealing, taxable expenditures, and excess contributions involving black lung benefit trusts) shall file an annual return with respect to the tax on the form prescribed by the Internal Revenue Service for that purpose. The person liable for the tax shall include the information required by the form and its related instructions.

[T.D. 7368, 40 FR 29843, July 16, 1975, as amended by T.D. 7838, 47 FR 44249, Oct. 7, 1982; T.D. 8026, 50 FR 20757, May 20, 1985; T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 8705, 62 FR 26, Jan. 2, 1997; T.D. 9334, 72 FR 36872, July 6, 2007]

§ 53.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

(a) *In general.* If a transaction is identified as a *listed transaction* or a *transaction of interest* as defined in § 1.6011–4 of this chapter by the Commissioner in published guidance (see § 601.601(d)(2)(ii)(*b*) of this chapter), and the listed transaction or transaction of interest involves an excise tax under chapter 42 of subtitle D of the Internal Revenue Code (relating to private foundations and certain other tax-exempt organizations), the transaction must be disclosed in the manner stated in such published guidance.

(b) *Effective/applicability date.* This section applies to listed transactions entered into on or after January 1, 2003. This section applies to transactions of interest entered into on or after November 2, 2006.

[T.D. 9350, 72 FR 43154, Aug. 3, 2007]

§ 53.6060–1 Reporting requirements for tax return preparers.

(a) *In general.* A person that employs one or more tax return preparers to prepare a return or claim for refund of tax under Chapter 42 of the Internal

Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6061–1 Signing of returns and other documents.

Any return, statement, or other document required to be made with respect to a tax imposed by Chapter 42 or the regulations thereunder shall be signed by the person required to file such return, statement or document, or by such other persons required or duly authorized to sign in accordance with the regulations, forms or instructions prescribed with respect to such return, statement or other document. The person required or duly authorized to make the return may incur liability for penalties provided for erroneous, false or fraudulent returns. For criminal penalties see sections 7201, 7203, 7206, and 7207.

§ 53.6065–1 Verification of returns.

(a) *Penalties of perjury.* If a return, statement, or other document made under the provisions of Chapter 42 or Subtitle F of the Code or the regulations thereunder with respect to any tax imposed by Chapter 42 of the Code, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of Chapter 42 or Subtitle F of the Code or regulations thereunder with respect to any tax imposed by Chapter 42 of the Code may be required to contain or be verified by a written declaration that it is made under the penalties of perjury.

(b) *Oath.* Any return, statement, or other document required to be submitted under Chapter 42 or Subtitle F of the Code or regulations prescribed thereunder with respect to any tax imposed by Chapter 42 of the Code may be required to be verified by an oath.

§ 53.6071–1 Time for filing returns.

(a) *General rule.* Except as otherwise provided in this section, a return required by § 53.6011–1 shall be filed at the time the private foundation or trust described in section 4947(a)(2) is required to file its annual information or tax return under section 6033 or 6012 (as may be applicable).

(b) *Exception.* The Form 4720 of a person whose taxable year ends on a date other than that on which the taxable year of the foundation or trust ends shall be filed on or before the 15th day of the fifth month following the close of such person's taxable year.

(c) *Form 5227.* A Form 5227 required to be filed by paragraph (d) of § 53.6011–1 for a trust described in section 4947(a) shall be filed on or before the 15th day of the fourth month following the close of the trust's taxable year.

(d) *Taxes related to black lung benefit trusts.* Forms 990–BL and 6069 shall be filed on or before the 15th day of the fifth month following the close of the filer's taxable year.

(e) *Taxes related to political expenditures of organizations described in section 501(c)(3) of the Internal Revenue Code.* A Form 4720 required to be filed by § 53.6011–1(b) for an organization liable for tax imposed by section 4955(a) must be filed by the unextended due date for filing its annual information return under section 6033 or, if the organization is exempt from filing, the date the organization would be required to file an annual information return if it was not exempt from filing. The Form 4720 of a person whose taxable year ends on a date other than that on which the taxable year of the organization described in section 501(c)(3) ends must be filed on or before the 15th day of the fifth month following the close of the person's taxable year.

(f) *Taxes imposed on excess benefit transactions engaged in by organizations described in sections 501(c)(3) (except private foundations) and 501(c)(4)*—(1) *General rule.* A Form 4720 required by § 53.6011–1(b) for a disqualified person or

organization manager liable for tax imposed by section 4958(a) shall be filed by that person on or before the 15th day of the fifth month following the close of such person's taxable year.

(2) *Special rule for taxable years ending after September 13, 1995, and on or before July 30, 1996.* A Form 4720 required by § 53.6011–1(b) for a disqualified person or organization manager liable for tax imposed by section 4958(a) on an excess benefit transaction occurring in such person's taxable year ending after September 13, 1995, and on or before July 30, 1996, is due on or before December 15, 1996.

(g) [Reserved] For further guidance, see § 53.6071–1T(g).

(h) *Effective/applicability date.* For the applicability date of paragraph (g) of this section, see § 53.6071–1T(h).

[T.D. 7368, 40 FR 29843, July 16, 1975, as amended by T.D. 7407, 41 FR 9322, Mar. 4, 1976; T.D. 7838, 47 FR 44249, Oct. 7, 1982; T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 8736, 62 FR 52257, Oct. 7, 1997; T.D. 9334, 72 FR 36872, July 6, 2007]

§ 53.6071–1T Time for filing returns (temporary).

(a) through (f) [Reserved] For further guidance, see § 53.6071–1(a) through (f).

(g) *Taxes imposed with respect to prohibited tax shelter transactions to which tax-exempt entities are parties*—(1) *Returns by certain tax-exempt entities.* A Form 4720, ''Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code,'' required by § 53.6011–1(b) for a tax-exempt entity described in section 4965(c)(1), (c)(2) or (c)(3) that is a party to a prohibited tax shelter transaction and is liable for tax imposed by section 4965(a)(1) shall be filed on or before the due date (not including extensions) for filing the tax-exempt entity's annual information return under section 6033(a)(1). If the tax-exempt entity is not required to file an annual information return under section 6033(a)(1), the Form 4720 shall be filed on or before the 15th day of the fifth month after the end of the tax-exempt entity's taxable year or, if the entity has not established a taxable year for Federal income tax purposes, the entity's annual accounting period.

(2) *Returns by entity managers of tax-exempt entities described in section 4965(c)(1), (c)(2) or (c)(3).* A Form 4720, required by § 53.6011–1(b) for an entity manager of a tax-exempt entity described in section 4965(c)(1), (c)(2) or (c)(3) who is liable for tax imposed by section 4965(a)(2) shall be filed on or before the 15th day of the fifth month following the close of the entity manager's taxable year during which the entity entered into the prohibited tax shelter transaction.

(3) *Transition rule.* A Form 4720, for a section 4965 tax that is or was due on or before October 4, 2007 will be deemed to have been filed on the due date if it is filed by October 4, 2007 and if all section 4965 taxes required to be reported on that Form 4720 are paid by October 4, 2007.

(h) *Effective/applicability date*—(1) *In general.* Paragraph (g) of this section is applicable on July 6, 2007.

(2) *Expiration date.* Paragraph (g) of this section will expire on July 6, 2010.

[T.D. 9334, 72 FR 36872, July 6, 2007; 72 FR 45895, Aug. 16, 2007]

§ 53.6081–1 Automatic extension of time for filing the return to report taxes due under section 4951 for self-dealing with a nuclear decommissioning fund.

(a) *In general.* A ''disqualified person'' for purposes of section 4951(e)(4) who engaged in self-dealing with a Nuclear Decommissioning Fund, and must report tax due under section 4951 on Form 1120-ND, ''Return for Nuclear Decommissioning Funds and Certain Related Persons,'' will be allowed an automatic 6-month extension of time to file the return after the date prescribed for filing the return if the disqualified person files an application under this section in accordance with paragraph (b) of this section. For guidance on requesting an extension of time to file Form 1120-ND for purposes of reporting contributions received, income earned, administrative expenses of operating the fund, and the tax on modified gross income, see § 1.6081–3 of this chapter.

(b) *Requirements.* To satisfy this paragraph (b), a disqualified person must—

(1) Submit a complete application on Form 7004, ''Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and

Other Returns,'' or in any other manner prescribed by the Commissioner;

(2) File the application on or before the date prescribed for filing the return with the Internal Revenue Service office designated in the application's instructions; and

(3) Remit the amount of the properly estimated unpaid tax liability on or before the date prescribed for payment.

(c) *No extension of time for the payment of tax.* An automatic extension of time for filing a return granted under paragraph (a) of this section will not extend the time for payment of any tax due on such return.

(d) *Termination of automatic extension.* The Commissioner may terminate an automatic extension at any time by mailing to the disqualified person a notice of termination at least 10 days prior to the termination date designated in such notice. The Commissioner must mail the notice of termination to the address shown on the Form 7004 or to the disqualified person's last known address. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter.

(e) *Penalties.* See section 6651 for failure to file or failure to pay the amount shown as tax on the return.

(f) *Effective/applicability dates.* This section is applicable for applications for an automatic extension of time to file a return to report taxes due under section 4951 for self-dealing with a Nuclear Decommissioning Fund filed after July 1, 2008.

[T.D. 9407, 73 FR 37369, July 1, 2008]

§ 53.6091–1 Place for filing chapter 42 tax returns.

Except as provided in § 53.6091–2 (relating to exceptional cases):

(a) *Persons other than corporations.* Chapter 42 tax returns of persons other than corporations shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the legal residence or principal place of business of the person required to make the return.

(b) *Corporations.* Chapter 42 tax returns of corporations shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the principal place of business or principal office or agency of the corporation.

(c) *Returns filed with service centers.* Notwithstanding paragraphs (a) and (b) of this section, unless a return is filed by hand carrying, whenever instructions applicable to Chapter 42 tax returns provide that the returns be filed with a service center, the returns must be so filed in accordance with the instructions. Returns which are filed by hand carrying shall be filed with any person assigned the responsibility to receive hand-carried returns in the local Internal Revenue Service office in accordance with paragraphs (a) or (b) of this section, whichever is applicable.

(d) *Returns of persons subject to a termination assessment.* Notwithstanding paragraph (c) of this section, income tax returns of persons with respect to whom a chapter 42 tax assessment was made under section 6852(a) with respect to the taxable year must be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office as provided in paragraphs (a) and (b) of this section.

[T.D. 7368, 40 FR 29843, July 16, 1975, as amended by T.D. 7495, 42 FR 33727, July 1, 1977; T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 53.6091–2 Exceptional cases.

Notwithstanding the provisions of § 53.6091–1, the Commissioner may permit the filing of any Chapter 42 tax return in any local Internal Revenue Service office.

[T.D. 7368, 40 FR 29843, July 16, 1975. Redesignated by T.D. 8084, 51 FR 16303, May 2, 1986, as amended by T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 53.6107–1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.

(a) *In general.* A person who is a signing tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the taxpayer and retain a completed copy or record in the manner stated in § 1.6107–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund filed.

(a) *In general.* Each tax return or claim for refund under Chapter 42 of the Internal Revenue Code prepared by one or more signing tax return preparers must include the identifying number of the preparer required by § 1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in § 1.6109–2 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6151–1 Time and place for paying tax shown on returns.

The Chapter 42 tax shown on any return shall, without assessment or notice and demand, be paid to the internal revenue officer with whom the return is filed at the time and place for filing such return (determined without regard to any extension of time for filing the return). For provisions relating to the time and place for filing such return, see §§ 53.6071–1 and 53.6091–1. For provisions relating to the extension of time for paying the tax, see § 53.6161–1.

§ 53.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by Chapter 42 and shown or required to be shown on any return, may be granted by the district directors and directors of the service centers at the request of the taxpayer. The period of such extension shall not be in excess of 6 months from the date fixed for payment of such tax, except that if the taxpayer is abroad the period of the extension may be in excess of 6 months.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by Chapter 42 may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand, and, in exceptional cases for a further period not in excess of 12 months. No extension of the time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished.* The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof unless so specified in the extension.

(b) *Undue hardship required for extension.* An extension of the time for payment shall be granted only upon a satisfactory showing that payment on the due date of the amount with respect to which the extension is desired will result in an undue hardship. The extension will not be granted upon a general statement of hardship. The term ''undue hardship'' means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer from making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

(c) *Application for extension.* An application for an extension of the time for payment of the tax shown or required to be shown on any return, or for the payment of any amount determined as a deficiency shall be made on Form 1127 and shall be accompanied by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. Such application shall also be accompanied by a statement of the assets and liabilities of the taxpayer and an itemized statement showing all receipts and disbursements for each of the three months immediately preceding the due date of the amount to which the application relates. The application, with supporting

documents, must be filed on or before the date prescribed for payment of the amount with respect to which the extension is desired with the internal revenue officer to whom the tax is to be paid. The application will be examined, and within 30 days, if possible, will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. If an additional extension is desired, the request therefor must be made on or before the expiration of the period for which the prior extension is granted.

(d) *Payment pursuant to extension.* If an extension of time for payment is granted, the amount the time for payment of which is so extended shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand. The granting of an extension of the time for payment of the tax or deficiency does not relieve the taxpayer from liability for the payment of interest thereon during the period of the extension. See section 6601 and § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

§ 53.6165–1 Bonds where time to pay tax or deficiency has been extended.

If an extension of time for payment of tax or deficiency is granted under section 6161, the district director or the director of the service center may, if he deems it necessary, require a bond for the payment of the amount in respect of which the extension is granted in accordance with the terms of the extension. However, such bond shall not exceed double the amount with respect to which the extension is granted. For provisions relating to form of bonds, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

§ 53.6601–1 Interest on underpayment, nonpayment, or extensions of time for payment, of tax.

For regulations concerning interest on underpayment, nonpayment, or extensions of time for payment of tax, see § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

§ 53.6651–1 Failure to file tax return or to pay tax.

(a) *General rules.* For general rules relating to the failure to file tax return or to pay tax, see the regulations under section 6651 contained in part 301 of this chapter (Regulations on Procedure and Administration).

(b) *Special rule where foundation files return.* (1) Except as provided in paragraph (b)(2) of this section, in the case of tax imposed by section 4941(a)(1) on any disqualified person, reasonable cause shall be presumed, for purposes of section 6651(a)(1), where the private foundation or trust described in section 4947(a)(2) files a return in good faith and such return indicates no tax liability with respect to such tax on the part of such disqualified person.

(2) Paragraph (b)(1) of this section shall not apply where the disqualified person knew of facts which, if known by the foundation, would have precluded the foundation from making the return, as filed, in good faith.

§ 53.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general.* For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund under Chapter 42 of the Internal Revenue Code, see § 1.6694–1 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection when a tax return preparer who prepared a return or claim for refund of tax under Chapter 42 of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 53.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 53.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules for claims for credit or refund by a tax return preparer who prepared a return or claim for refund for tax under Chapter 42 of the Internal Revenue Code, the rules under § 1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 53.7101–1 Form of bonds.

For provisions relating to form of bonds, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

§ 53.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see § 301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

PART 54—PENSION EXCISE TAXES

Sec.

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54.9811–1 Standards relating to benefits for mothers and newborns.

54.9812–1T Parity in the application of certain limits to mental health benefits (temporary).
54.9831–1 Special rules relating to group health plans.
54.9833–1 Effective dates.

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Section 54.9831–1 also issued under 26 U.S.C. 9833;

Section 54.9833–1 also issued under 26 U.S.C. 9833.

§ 54.4971–1 General rules relating to excise tax on failure to meet minimum funding standards.

(a)–(b) [Reserved]

(c) *Additional tax.* Section 4971(b) imposes an excise tax in any case in which an initial tax is imposed under section 4971(a) on an accumulated funding deficiency and the accumulated funding deficiency is not corrected within the taxable period (as defined in section 4971(c)(3)). The additional tax is 100 percent of the accumulated funding deficiency to the extent not corrected.

(d) [Reserved]

(e) *Definition of taxable period*—(1) *In general.* For purposes of any accumulated funding deficiency, the term ''taxable period'' means the period beginning with the end of the plan year in which there is an accumulated funding deficiency and ending on the earlier of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed by section 4971(a), or

(ii) The date on which the tax imposed by section 4971(a) is assessed.

(2) *Special rule.* Where a notice of deficiency referred to in paragraph (e)(1)(i) of this section is not mailed because a waiver of the restrictions on assessment and collection of a deficiency has been accepted or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

[T.D. 8084, 51 FR 16305, May 2, 1986]

§ 54.4972–1 Tax on excess contributions to plans benefiting self-employed individuals.

(a) *In general.* Section 4972 imposes a tax of 6 percent on the amount of the excess contributions (as defined in section 4972 (b) and (c) of this section) under certain qualified plans (as defined in paragraph (b) of this section) for each taxable year beginning after December 31, 1975, of the employer who maintains such plan. Partnerships and sole proprietors are to report this tax by filing Form 5330 (or other designated form) and the tax is to be paid annually at the time prescribed for filing such return (determined without regard to any extension of time for filing).

(b) *Employers to whom section applies.* The tax under section 4972 is imposed on employers who maintain a qualified plan during their taxable year. For this purpose, the term *qualified plan* means a pension or profit-sharing plan which includes a trust described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a). In addition to being a qualified plan, the plan must provide contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1). For this purpose, the plan does not have to provide contributions or benefits for employees who are employees within the meaning of section 401(c)(1) during the taxable year; it is sufficient that the plan so provided in a prior taxable year.

(c) *Excess contributions*—(1) *In general.* For a taxable year of an employer for purposes of section 4972 and this section, the term ''excess contributions'' means:

(i) The amount (if any) by which the sum of:

(A) The amount (if any) determined under section 4972(b)(2) and paragraph (d) of this section, plus

(B) The amount (if any) determined under section 4972(b)(3) and paragraph (e) of this section, plus

(C) The amount (if any) determined under section 4972(b)(4) and paragraph (f) of this section, exceeds

(ii) The amount (if any) of any correcting distributions (as defined in section 4972(b)(5) and paragraph (g) of this section) made in all prior taxable years beginning after December 31, 1975.

(2) *Contributions allocable to insurance.* For purposes of section 4972(b) and this section, the amount of any contribution made under the plan which is allocable to the purchase of life, accident, health, or other insurance is not taken into account. The amount of any contribution which is allocable to the cost of insurance protection is determined in accordance with the provisions of paragraph (g) of § 1.404(e)–1A and paragraph (b) of § 1.72–16.

(d) *Contributions by owner-employees*—(1) *General rule.* In the case of a plan which provides contributions or benefits for employees some or all of whom are owner-employees, within the meaning of section 401(c)(3), the amount determined under section 4972(b)(2) and this paragraph for the employer's taxable year is the amount computed separately with respect to each owner-employee equal to the sum of:

(i) The excess (if any) of

(A) The amount contributed under the plan by each owner-employee as an employee (that is, each owner-employee's contributions within the meaning of section 401(c)(5)(B)) for such taxable year of the employer, over

(B) The amount permitted under section 4972(c) and paragraph (h) of this section to be contributed by each owner-employee as an employee for such taxable year of the employer, and

(ii) The amount determined under section 4972(b)(2) and this paragraph for the immediately preceding taxable year of the employer, reduced by the excess (if any) of the amount described in subdivision (1)(B) of this subparagraph over the amount described in subdivision (1)(A) of this subparagraph for such taxable year of the employer.

(2) *Rollover amounts.* The provisions of section 4972 (c) and paragraph (d) of this section are not applicable to amounts contributed on behalf of an owner-employee in a rollover contribution described in section 402(a)(5), 403(a)(4), 408(d)(3), or 409(b)(3)(C).

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

Example 1. (i) A and B are the only owner-employees covered under the X Employees' Trust. The X Partnership, the X Trust, and

the X Plan all use the calendar year as their annual accounting period, at all relevant times. The amount determined under section 4972(b)(2) for 1975 is 0 because this section does not apply to contributions made for taxable years beginning before January 1, 1976. In calendar year 1976, A contributes $2,500 and B contributes $2,500 to the trust. The amount permitted to be contributed to the trust for 1976 with respect to A as an employee is $1,800 and with respect to B as an employee is $2,200.

(ii) The amount determined under this paragraph for 1976 with respect to A is $700, computed as follows: the sum of the excess of the amount contributed by A ($2,500) over the amount permitted to be contributed by A ($1,800), and the amount determined under this paragraph for A in 1975 (0).

(iii) The amount determined under this paragraph for 1976 with respect to B is $300, computed as follows: the sum of the excess of the amount contributed by B ($2,500) over the amount permitted to be contributed by B ($2,200), and the amount determined under this paragraph for B in 1975 (0).

(iv) The amount determined under section 4972(b)(2) and this paragraph for 1976 with respect to the employer, X Partnership, is $1,000, the sum of the amounts determined separately under this paragraph with respect to A ($700) and B ($300). The tax under section 4972 for 1976 on the X Partnership (assuming that no other events affecting the determination of the tax under section 4972 occur) is 6 percent of $1,000 or $60.

Example 2. (i) Assume the facts stated in Example (1). In calendar year 1977, A contributes $1,500 and B contributes $2,300 to the trust. Assume that the amount permitted to be contributed to the trust for 1977, under section 4972(c) for A and B is $2,500 each.

(ii) The amount determined under this paragraph for 1977 with respect to A is 0, computed as follows: the sum of 0 (the excess of the amount contributed by A ($1,500) over the amount permitted to be contributed ($2,500)) and $700, the amount determined under this paragraph for A in 1976, reduced by $1,000 (the amount permitted to be contributed by A ($2,500) over the amount contributed by A ($1,500)).

(iii) The amount determined under this paragraph for 1977 with respect to B is $100, computed as follows: the sum of 0 (the excess of the amount contributed by B ($2,300) over the amount permitted to be contributed ($2,500)) and $300, the amount determined under this paragraph for B in 1976, reduced by $200 (the amount permitted to be contributed ($2,500) by B over the amount contributed by B ($2,300)).

(iv) The amount determined under section 4972(b) and this paragraph for 1977 with respect to the employer, X Partnership, is $100, the sum of the amounts determined separately under this paragraph with respect to A ($0) and B ($100). The tax imposed under section 4972 for 1977 on the X Partnership (assuming that no other events affecting the determination of the tax under section 4972 occur) is 6 percent of $100, or $6.

(e) *Defined benefit plans*—(1) *General rule.* In the case of a defined benefit plan (as defined in section 414(j)), the amount determined under section 4972(b)(3) and this paragraph for the taxable year of the employer is the amount contributed under the plan by the employer during the taxable year plus the amounts, if any, contributed by the employer during any prior taxable year beginning after December 31, 1975, if:

(i) As of the close of the taxable year, the full funding limitation of the plan (determined under section 412(c)(7) and the regulations thereunder) is zero, and

(ii) Such amounts contributed have not been deductible by the employer for the taxable year or for any prior taxable year beginning after December 31, 1975.

See section 404 and the regulations thereunder for the determination of the amount deductible by the employer for the taxable year. If the amounts contributed by the employer exceed the amounts which have been deductible, the amount determined under this paragraph shall not exceed the amounts which have not been deductible. For purposes of this paragraph, the determination of both the amounts contributed and the amounts deductible by the employer for any relevant taxable year includes amounts contributed and deductible on behalf of any employee covered under the plan, including common-law employees and other self-employed individuals who are not owner-employees in addition to owner-employees. The determination of whether the full funding limitation is zero shall be made taking into account all the plan assets unreduced by any deduction carryover under section 404(a)(1)(D). The determination of whether the full funding limitation is zero as of the close of the employer's taxable year shall be made with respect to the plan year ending with or within the employer's taxable year. Consequently, if an employer whose taxable year is the calendar year establishes and maintains a defined benefit

plan whose plan year begins on July 1 and ends on June 30, the full funding limitation for that plan will be determined with respect to the plan year ending on June 30 within the calendar taxable year including that June 30.

(2) *Illustration*. The provisions of this paragraph may be illustrated by the following example:

Example. (i) X Partnership (''X'') adopts the Y Defined Benefit Plan (''Y Plan'') on January 1, 1977. The taxable year of X is the calendar year. The Y Plan also has a calendar plan year. For 1977, $25,000 is contributed to the Y Plan by X. Assume that for 1977, (1) only $10,000 is deductible by X for 1977 under section 404 and (2) the full funding limitation of the Y Plan (determined under section 412(c)(7)) on December 31, 1977, is greater than zero. For 1978, X makes no additional contributions to the Y Plan. Assume that for 1978, (1) no amount is deductible by X under section 404 and (2) the full funding limitation of the Y Plan (determined under section 412(c)(7)) on December 31, 1978, is zero. The amount determined under section 4972(b)(3) and this paragraph for the 1978 taxable year is $15,000, computed as follows: the difference between (A) the sum of the amounts contributed by X for taxable year 1978 (0), and the amounts contributed by X for taxable year 1977 ($25,000) and (B) the sum of the amount deductible for taxable year 1978 (0) and the amount deductible for taxable year 1977 ($10,000). The tax imposed under section 4972 for 1978 on X (assuming that no other events affecting the determination of the tax under section 4972 occur) is 6 percent of $15,000 or $900.

(ii) For 1979, X makes no additional contributions to the Y Plan. Assume that for 1979, (1) the full funding limitation of the Y Plan determined under section 412(c)(7) is greater than zero. Assume further that $10,000 of the amounts contributed for 1977 is deductible by X for 1979 under section 404. There is no amount determined under section 4972(b)(3) and this paragraph for 1979 because the condition described in subparagraph (1)(i) of this paragraph is not satisfied.

(iii) For 1980, X makes no additional contributions to the Y Plan. Assume that for 1980, (1) no amount is deductible under section 404 and (2) the full funding limitation of the Y Plan (determined under section 412(c)(7)) on December 31, 1980, is zero. The amount determined under section 4972(b)(3) and this paragraph for the 1980 taxable year is $5,000, computed as follows: the difference between (A) $25,000, the sum of the amounts contributed by X for taxable years 1980 (0), 1979 (0), 1978 (0), and 1977 ($25,000) and (B) $20,000, the sum of the amounts deductible for taxable years 1980 (0), 1979 ($10,000), 1978 (0), and 1977 ($10,000). The tax imposed under section 4972 for 1980 on X (assuming that no other events affecting the determination of the tax under section 4972 occur) is 6 percent of $5,000, or $300.

(f) *Defined contribution plans*—(1) *General rule*. In the case of a defined contribution plan (as defined in section 414(i)), the amount determined under section 4972(b)(4) and this paragraph for the taxable year of the employer is equal to the portion of the amounts contributed under the plan by the employer during the taxable year plus the amounts contributed by the employer during any prior taxable year beginning after December 31, 1975, which has not been deductible by the employer for the taxable year or for any such prior taxable year. For purposes of this paragraph, the determination of both the amounts contributed and the amounts deductible by the employer for any relevant taxable year includes amounts contributed and deductible on behalf of any employee covered under the plan, including common-law employees and other self-employed individuals who are not owner-employees in addition to owner-employees.

(2) *Illustration*. The provisions of this paragraph may be illustrated by the following example:

Example. (i) The X Partnership (''X'') adopts the Z Defined Contribution Plan and Trust (''Z Plan'') on January 1, 1976. X's taxable year and the plan year of Z Plan are both calendar years. For 1976, X contributes $40,000, of which $30,000 is deductible under section 404 for taxable year 1976. The amount determined under section 4972(b)(4) and this paragraph for 1976 is $10,000 (the difference between (A) $40,000, the amount contributed by X for taxable year 1976 and (B) $30,000, the amount deductible for taxable year 1976).

(ii) For 1977, X contributes $25,000, and the amounts deductible by X under section 404 for taxable year 1977 is $30,000 ($5,000 for the contribution carryover from 1976 and $25,000 with respect to the 1977 contribution). The amount determined under section 4972(b)(4) and this paragraph for 1977 is $5,000, computed as follows: the difference between (A) $65,000, the sum of the amounts contributed by X for taxable year 1976 ($40,000) and the amounts contributed by X for taxable year 1977 ($25,000), and (B) $60,000, the sum of the amounts deductible for taxable year 1976 ($30,000) and the amounts deductible for taxable year 1977 ($30,000).

(g) *Correcting distribution*—(1) *General rule*. For purposes of section 4972(b) and

this paragraph, the term ''correcting distribution'' means, for the taxable year of the employer, the sum of:

(i) In the case of a contribution made as an employee by an owner-employee, within the meaning of section 401(c)(3), to a defined benefit or defined contribution plan, the amount, or any part thereof, determined under section 4972(b)(2) and paragraph (d) of this section which is distributed to the owner-employee who contributed such amount to the plan;

(ii) In the case of a defined benefit plan, the amount, or any part thereof, determined under section 4972(b)(3) and paragraph (e) of this section which is distributed from the plan to the employer, and

(iii) In the case of a defined contribution plan, the amount, or any part thereof, determined under section 4972(b)(4) and paragraph (f) of this section which is distributed to (A) the employer or (B) to the employee for whom such amount was contributed.

If, for any employer taxable year in which a defined contribution plan is maintained, there is a correcting distribution to an employee which could be from amounts described in subparagraph (1)(i) and (iii) of this paragraph for such employee, then such correcting distribution shall be deemed to be made first from amounts described in such subparagraph (1)(i) and then from amounts described in such subparagraph (1)(iii) for purposes of this section and section 72. For the income tax treatment of such distributions to employees, see section 72 and the regulations thereunder. Any such distributions to employees shall not be subject to the tax imposed by section 4975 nor result in the defined contribution plan failing to satisfy the exclusive benefit requirement of section 401(a), solely by reason of being a correcting distribution within the meaning of this paragraph. If, for any employer taxable year in which a defined benefit, or defined contribution plan is maintained, there is a correcting distribution described in subparagraph (1)(ii) or (iii) of this paragraph to the employer maintaining the plan, such distribution shall not be subject to the tax imposed by section 4975 nor result in the plan's failing to satisfy the exclusive benefit or the definitely determinable requirements under section 401(a). If, for any employer taxable year in which a money purchase pension plan is maintained, a correcting distribution described in subparagraph (1)(iii) of this paragraph is made to an employee who has not yet become eligible to receive retirement benefits under the plan, the qualification of the pension plan (and trust) under section 401(a) may be adversely affected. See § 1.401–1(b)(1)(i). A correcting distribution described in subparagraph (1)(iii) of this paragraph to an owner-employee prior to age 59½ must be precluded under the plan. See section 401(d)(4)(B).

(2) *Illustration*. The provisions of this paragraph may be illustrated by the following example:

Example. (i) A and B are owner-employees who are over the age of 59½ and who are covered under the X Employees' Defined Contribution Plan and Profit-Sharing Trust (''Plan Y''). The X Partnership (''X'') and Plan Y are on calendar years. In calendar year 1976, A contributes $2,500 and B contributes $2,500 to Plan Y. The amount permitted to be contributed to Plan Y for 1976 with respect to A as an employee is $1,800 and with respect to B as an employee is $2,200. X contributes to Plan Y $5,000 on behalf of A and $5,000 on behalf of B. Of this amount, assume that $2,700 is deductible with respect to A and $3,300 is deductible with respect to B by X under section 404. The amount determined under section 4972(b)(2) and paragraph (d) of this section (the excess owner-employee contributions made by A and B to Plan Y) for taxable year 1976 is $1,000, computed as follows: the sum of (A) for A, $700, the difference between his own contributions ($2,500) and the amount permitted to be contributed by A ($1,800) and (B) for B, $300, the difference between his own contributions ($2,500) and the amount permitted to be contributed by B ($2,200). The amount determined under section 4972(b)(4) and paragraph (f) of this section (the excess contributions made by X to Plan Y) for taxable year 1976 is $4,000, computed as follows: the sum of (A) by X for A, $2,300, the difference between contributions by X ($5,000) and the amount deductible by X for A ($2,700) and (B) by X for B, $1,700, the difference between contributions by X for B ($5,000) and the amount deductible by X for B ($3,300). During 1976, there is no correcting distribution, within the meaning of section 4972 and this paragraph, because there are no distributions to A, B, or X.

(ii) Assume that, for taxable year 1977, the amounts determined under sections 4972(b)(2) and 4972(b)(4) remain the same as for taxable

year 1976, that is, $1,000 ($700 for A and $300 for B) and $4,000 ($2,300 by X for A and $1,700 by X for B), respectively. Assume further that, in 1977, Plan Y distributes $3,000 to A and $1,000 to B. The amount determined under section 4972(b)(5) and this paragraph (the correcting distribution for Plan Y) for taxable year 1977 is $4,000, computed and attributed as follows: the sum of (A) $3,000 with respect to A, the amount of the distribution to A applied first to A's $700 amount described in subparagraph (1)(i) of this paragraph and next to A's $2,300 amount described in subparagraph (1)(iii) of this paragraph and (B) $1,000 with respect to B, the amount of the distribution to B applied first to B's $300 amount described in subparagraph (1)(i) of this paragraph and next to B's $1,700 amount described in subparagraph (1)(iii) of this paragraph. For purposes of computing the excess contributions for taxable year 1977, the correcting distribution of $4,000 would not be taken into account because only correcting distributions for prior year are considered. However, for taxable year 1978 the correcting distribution of $4,000 would be taken into account.

(iii) Assume that, for taxable year 1978, there are no additional amounts determined under sections 4972(b)(2) and 4972(b)(4) and that Plan Y distributes $900 to B. The amount determined under section 4972(b)(5) and this paragraph (the correcting distribution for Plan Y) for the 1978 taxable year is $900, computed and attributed as follows: the amount of the distribution to B, $900, applied to B's $1,000 amount described in subparagraph (1)(iii) of this paragraph. For purposes of computing the excess contributions for taxable year 1978, the correcting distribution of $900 would not be taken into account. However, for taxable year 1979, the correcting distribution of $900 would be taken into account.

(h) *Amount permitted to be contributed by owner-employee*—(1) *General rule*. Except as provided in subparagraph (2), for purposes of section 4972(b)(2) and paragraph (d), the amount permitted to be contributed under a plan by an owner-employee as an employee for any taxable year of the employer is the smallest of the following:

(i) $2,500;

(ii) 10 percent of the earned income (as defined in section 401(c)(2)) for such taxable year derived by the owner-employee from the trade or business with respect to which the plan is established, or

(iii) The amount of the contribution which would be contributed by the owner-employee (as an employee) if such contribution were made at the rate of contributions which is permitted to be made by employees who are not owner-employees during such taxable year.

(2) *Special rule*. In the case of a taxable year of the employer in which there are no employees other than owner-employees, the amount permitted to be contributed under a plan by an owner-employee (as an employee) is zero.

(i) *Special rules and cross references*—(1) *Time of contributions*. For purposes of this section, time of employer contributions made with respect to any taxable year shall take into account the rules specified in section 404(a)(6), relating to time when contributions deemed made.

(2) *Disallowance of deduction*. For disallowance of deduction for taxes paid under this section, see section 275(a)(6).

(3) *Certain annuity contracts*. For a special rule relating to owner-employee contributions for premiums on annuity, etc. contracts, see § 1.401(e)4(a)

(4) *Disqualification for excess contributions*. For plan qualification requirements relating to excess contributions, see section 401(d)(5).

[T.D. 7759, 46 FR 6932, Jan. 22, 1981]

§ 54.4974–1 Excise tax on accumulations in individual retirement accounts or annuities.

(a) *General rule*. A tax equal to 50 percent of the amount by which the minimum amount required to be distributed from an individual retirement account or annuity described in section 408 during the taxable year of the payee under paragraph (b) of this section exceeds the amount actually distributed during the taxable year is imposed by section 4974 on the payee.

(b) *Minimum amount required to be distributed*. For purposes of this section, the minimum amount required to be distributed is the amount required under § 1.408–2(b)(6)(v) to be distributed in the taxable year described in paragraph (a) of this section.

(c) *Examples*. The application of this section may be illustrated by the following examples.

Example 1. In 1975, the minimum amount required to be distributed under § 1.408–2(b)(6)(v) to A under his individual retirement account is $100. Only $60 is actually

distributed to A in 1975. Under section 4974, A would have an excise tax liability of $20 [50% of ($100 – $60)].

Example 2. Although no distribution is required under § 1.408–2(b)(6)(v) to be made in 1986, H, a married individual born on February 1, 1921, who has established and maintained an individual retirement account decides to begin receiving distributions from the account beginning in 1986. H's wife, W, was born on March 6, 1921. H and W are calendar year taxpayers. H decides to receive his interest in the account over the joint life and last survivor expectancy of himself and his wife. On January 1, 1986, the balance in H's account is $10,000; H and W, based on their nearest birthdates, are 65; and the joint life and last survivor expectancy of H and his wife is 22.0 years (see Table II of § 1.72–9). His annual payments during the following years (none of which were required) were determined by dividing the balance in the account on the first day of each year by the joint life and last survivor expectancy reduced by the number of whole years elapsed since the distributions were to commence.

Date	Life expectancy minus whole years elapsed	Account balance at beginning of each year	Annual payment
Jan. 1, 1986	22.0	$10,000	$455
Jan. 1, 1987	21.0	10,118	482
Jan. 1, 1988	20.0	10,214	511
Jan. 1, 1989	19.0	10,285	541
Jan. 1, 1990	18.0	10,329	574
Jan. 1, 1991	17.0	10,340	608

For 1986, 1987, 1989, and 1990, the amount required to be distributed under § 1.408–2(b)(6)(v) is zero. Thus, H would have no excise tax liability under section 4974 for these years. In 1991, the year H attains age 70½, the amount required to be distributed from the account under § 1.408–2(b)(6)(v) is $565, determined by dividing $10,340 (the account balance as of January 1, 1991) by 18.8 years (the joint life and last survivor expectancy of H and W, assuming they are both still living, as of January 1, 1991). If W should die after December 31, 1990, the joint life and last survivor expectancy determined on January 1, 1991 (18.3 years) would not be redetermined. Because the amount distributed from the account in 1991 ($608) exceeds the amount required to be distributed from the account in 1991 ($565), H has no excise tax liability under section 4974 for 1991.

Example 3. Assume the same facts as in example (2) except that W dies in 1988. For 1988, 1989, and 1990, the amount required to be distributed under § 1.408–2(b)(6)(v) is zero. Thus, H would have no excise tax liability under section 4974 for these years. In 1991, the amount required to be distributed under § 1.408–2(b)(6)(v) is $855, determined by dividing $10,340 (the account balance as of January 1, 1991) by 12.1 years (the life expectancy of H as of January 1, 1991). Because the amount distributed from the account in 1991 ($608) is less than the amount required to be distributed from the account in 1991 ($855), H has an excise tax liability of $123.50 under section 4974 for 1991 [50% of ($855 – $608)].

[T.D. 7714, 45 FR 52799, Aug. 8, 1980]

§ 54.4974–2 Excise tax on accumulations in qualified retirement plans.

Q–1. Is any tax imposed on a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) to whom an amount is required to be distributed for a taxable year if the amount distributed during the taxable year is less than the required minimum distribution?

A–1. Yes, if the amount distributed to a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) for a calendar year is less than the required minimum distribution for such year, an excise tax is imposed on such payee under section 4974 for the taxable year beginning with or within the calendar year during which the amount is required to be distributed. The tax is equal to 50 percent of the amount by which such required minimum distribution exceeds the actual amount distributed during the calendar year. Section 4974 provides that this tax shall be paid by the payee. For purposes of section 4974, the term required minimum distribution means the minimum distribution amount required to be distributed pursuant to section 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3), or 457(d)(2), as the case may be, and the regulations thereunder. Except as otherwise provided in A–6 of this section, the required minimum distribution for a calendar year is the required minimum distribution amount required to be distributed during the calendar year. A–6 of this section provides a special rule for amounts required to be distributed by an employee's (or individual's) required beginning date.

Q–2. FOR PURPOSES OF SECTION 4974, WHAT IS A QUALIFIED RETIREMENT PLAN?

A–2. For purposes of section 4974, each of the following is a qualified retirement plan—

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

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

(c) An annuity contract, custodial account, or retirement income account described in section 403(b);

(d) An individual retirement account described in section 408(a) (including a Roth IRA described in section 408A);

(e) An individual retirement annuity described in section 408(b) (including a Roth IRA described in section 408A); or

(f) Any other plan, contract, account, or annuity that, at any time, has been treated as a plan, account, or annuity described in paragraphs (a) through (e) of this A–2, whether or not such plan, contract, account, or annuity currently satisfies the applicable requirements for such treatment.

Q–3. If a payee's interest under a qualified retirement plan is in the form of an individual account, how is the required minimum distribution for a given calendar year determined for purposes of section 4974?

A–3. (a) *General rule*. If a payee's interest under a qualified retirement plan is in the form of an individual account and distribution of such account is not being made under an annuity contract purchased in accordance with A–4 of §1.401(a)(9)–6, the amount of the required minimum distribution for any calendar year for purposes of section 4974 is the required minimum distribution amount required to be distributed for such calendar year in order to satisfy the minimum distribution requirements in §1.401(a)(9)–5 as provided in the following (whichever is applicable)—

(1) Section 401(a)(9) and §§1.401(a)(9)–1 through 1.401(a)(9)–5 and 1.401(a)(9)–7 through 1.401(a)(9)–9 in the case of a plan described in section 401(a) which includes a trust exempt under section 501(a) or an annuity plan described in section 403(a);

(2) Section 403(b)(10) and §1.403(b)–6(e) (in the case of an annuity contract, custodial account, or retirement income account described in section 403(b));

(3) Section 408(a)(6) or (b)(3) and §1.408–8 (in the case of an individual retirement account or annuity described in section 408(a) or (b)); or

(4) Section 457(d) in the case of an eligible deferred compensation plan (as defined in section 457(b)).

(b) *Default provisions*. Unless otherwise provided under the qualified retirement plan (or, if applicable, the governing instrument of the qualified retirement plan), the default provisions in A–4(a) of §1.401(a)(9)–3 apply in determining the required minimum distribution for purposes of section 4974.

(c) *Five-year rule*. If the 5-year rule in section 401(a)(9)(B)(ii) applies to the distribution to a payee, no amount is required to be distributed for any calendar year to satisfy the applicable enumerated section in paragraph (a) of this A–3 until the calendar year which contains the date 5 years after the date of the employee's death. For the calendar year which contains the date 5 years after the employee's death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee's entire remaining interest in the qualified retirement plan.

Q–4. If a payee's interest in a qualified retirement plan is being distributed in the form of an annuity, how is the amount of the required minimum distribution determined for purposes of section 4974?

A–4. If a payee's interest in a qualified retirement plan is being distributed in the form of an annuity (either directly from the plan, in the case of a defined benefit plan, or under an annuity contract purchased from an insurance company), the amount of the required minimum distribution for purposes of section 4974 will be determined as follows:

(a) *Permissible annuity distribution option*. A permissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) which specifically provides for distributions which, if made as provided, would for every calendar year equal or exceed the minimum distribution amount required to be distributed

to satisfy the applicable section enumerated in paragraph (a) of A–2 of this section for every calendar year. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made is a permissible annuity distribution option, the required minimum distribution for a given calendar year will equal the amount which the annuity contract (or distribution option) provides is to be distributed for that calendar year.

(b) *Impermissible annuity distribution option.* An impermissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made that specifically provides for distributions which, if made as provided, would for any calendar year be less than the minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A–3 of this section. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, the distribution option) under which distributions to the payee are being made is an impermissible annuity distribution option, the required minimum distribution for each calendar year will be determined as follows:

(1) If the qualified retirement plan under which distributions are being made is a defined benefit plan, the minimum distribution amount required to be distributed each year will be the amount which would have been distributed under the plan if the distribution option under which distributions to the payee were being made was the following permissible annuity distribution option:

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the joint and survivor annuity option under the plan for the lives of the employee and the designated beneficiary that provides for the greatest level amount payable to the employee determined on an annual basis. If the plan does not provide such an option or there is no designated beneficiary under the impermissible distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the employee in level amounts with no survivor benefit.

(ii) In the case of distributions commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the designated beneficiary in level amounts. If there is no designated beneficiary, the 5-year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A–4. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary's life is to be used in the case of multiple beneficiaries will be made in accordance with § 1.401(a)(9)–4 and A–7 of § 1.401(a)(9)–5. If the defined benefit plan does not provide for distribution in the form of the applicable permissible distribution option, the required minimum distribution for each calendar year will be an amount as determined by the Commissioner.

(2) If the qualified retirement plan under which distributions are being made is a defined contribution plan and the impermissible annuity distribution option is an annuity contract purchased from an insurance company, the minimum distribution amount required to be distributed each year will be the amount that would have been distributed in the form of an annuity contract under the permissible annuity distribution option under the plan determined in accordance with paragraph (b)(1) of this A–4 for defined benefit plans. If the defined contribution plan does not provide the applicable permissible annuity distribution option, the required minimum distribution for each calendar year will be the amount that would have been distributed under an annuity described in paragraph (b)(2)(i) or (ii) of this A–4 purchased with the employee's or individual's account used to purchase the annuity contract that is the

impermissible annuity distribution option.

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity is a joint and survivor annuity for the lives of the employee and the designated beneficiary which provides level annual payments and which would have been a permissible annuity distribution option. However, the amount of the periodic payment which would have been payable to the survivor will be the applicable percentage under the table in A–2(c) of § 1.401(a)(9)–6 of the amount of the periodic payment which would have been payable to the employee or individual. If there is no designated beneficiary under the impermissible distribution option for purposes of section 401(a)(9), the annuity is a life annuity for the life of the employee with no survivor benefit which provides level annual payments and which would have been a permissible annuity distribution option.

(ii) In the case of a distribution commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity option is a life annuity for the life of the designated beneficiary which provides level annual payments and which would have been a permissible annuity distribution option. If there is no designated beneficiary, the 5-year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A–4. The amount of the payments under the annuity contract will be determined using the interest rate and actuarial tables prescribed under section 7520 determined using the date determined under A–3 of § 1.401(a)(9)–3 when distributions are required to commence and using the age of the beneficiary as of the beneficiary's birthday in the calendar year that contains that date. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary's life is to be used in the case of multiple beneficiaries will be made in accordance with § 1.401(a)(9)–4 and A–7 of § 1.401(a)(9)–5.

(3) If the 5-year rule in section 401(a)(9)(B)(ii) applies to the distribution to the payee under the contract (or distribution option), no amount is required to be distributed to satisfy the applicable enumerated section in paragraph (a) of this A–4 until the calendar year which contains the date 5 years after the date of the employee's death. For the calendar year which contains the date 5 years after the employee's death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee's entire remaining interest in the annuity contract (or under the plan in the case of distributions from a defined benefit plan).

(4) If the plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attained age 70½ in accordance with paragraph A–2(e) of § 1.401(a)(9)–2, the required minimum distribution for each calendar year for an employee who is not a 5-percent owner for purposes of this section will be the lesser of the amount determined based on the required beginning date as set forth in A–2(a) of § 1.401(a)(9)–2 or the required beginning date under the plan. Thus, for example, if an employee dies after attaining age 70½, but before April 1 of the calendar year following the calendar year in which the employee retired, and there is no designated beneficiary as of September 30 of the year following the employee's year of death, required minimum distributions for calendar years after the calendar year containing the employee's date of death may be based on either the applicable distribution period provided under either the 5-year rule of A–1 of § 1.401(a)(9)–3 or the employee's remaining life expectancy as set forth in A–5(c)(3) of § 1.401(a)(9)–5.

Q–5. If there is any remaining benefit with respect to an employee (or IRA owner) after any calendar year in which the entire remaining benefit is required to be distributed under section 401(a)(9), what is the amount of the required minimum distribution for

each calendar year subsequent to such calendar year?

A–5. If there is any remaining benefit with respect to an employee (or IRA owner) after the calendar year in which the entire remaining benefit is required to be distributed, the required minimum distribution for each calendar year subsequent to such calendar year is the entire remaining benefit.

Q–6. With respect to which calendar year is the excise tax under section 4974 imposed in the case in which the amount not distributed is an amount required to be distributed by April 1 of a calendar year (by the employee's or individual's required beginning date)?

A–6. In the case in which the amount not paid is an amount required to be paid by April 1 of a calendar year, such amount is a required minimum distribution for the previous calendar year, *i.e.*, for the employee's or the individual's first distribution calendar year. However, the excise tax under section 4974 is imposed for the calendar year containing the last day by which the amount is required to be distributed, *i.e.*, the calendar year containing the employee's or individual's required beginning date, even though the preceding calendar year is the calendar year for which the amount is required to be distributed. There is also a required minimum distribution for the calendar year which contains the employee's or individual's required beginning date. Such distribution is also required to be made during the calendar year which contains the employee's or individual's required beginning date.

Q–7. Are there any circumstances when the excise tax under section 4974 for a taxable year may be waived?

A–7. (a) *Reasonable cause*. The tax under section 4974(a) may be waived if the payee described in section 4974(a) establishes to the satisfaction of the Commissioner the following—

(1) The shortfall described in section 4974(a) in the amount distributed in any taxable year was due to reasonable error; and

(2) Reasonable steps are being taken to remedy the shortfall.

(b) *Automatic waiver*. The tax under section 4974 will be automatically waived, unless the Commissioner determines otherwise, if—

(1) The payee described in section 4974(a) is an individual who is the sole beneficiary and whose required minimum distribution amount for a calendar year is determined under the life expectancy rule described in §1.401(a)(9)–3 A–3 in the case of an employee's or individual's death before the employee's or individual's required beginning date; and

(2) The employee's or individual's entire benefit to which that beneficiary is entitled is distributed by the end of the fifth calendar year following the calendar year that contains the employee's or individual's date of death.

[T.D. 8987, 67 FR 19026, Apr. 17, 2002; 67 FR 35732, May 21, 2002, as amended by T.D. 9340, 72 FR 41160, July 26, 2007]

§ 54.4975–1 General rules relating to excise tax on prohibited transactions.

(a) *Scope*. This section provides general rules for the imposition of the excise taxes on prohibited transactions.

(b) *Initial tax*. Section 4975(a) imposes an initial tax on each prohibited transaction. The initial tax is 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period.

(c) *Additional tax*. Section 4975(b) imposes an excise tax in any case in which an initial tax is imposed under section 4975(a) on a prohibited transaction and the prohibited transaction is not corrected within the taxable period (as defined in paragraph (d) of this section). The additional tax is 100 percent of the amount involved with respect to the prohibited transaction.

(d) *Taxable period*—(1) *In general*. For purposes of any prohibited transaction, the term ''taxable period'' means the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed by section 4975(a);

(ii) The date on which correction of the prohibited transaction is completed; or

(iii) The date on which the tax imposed by section 4975(a) is assessed.

(2) *Special rule*. Where a notice of deficiency referred to in paragraph (d)(1)(i) of this section is not mailed because a waiver of the restrictions on assessment and collection of a deficiency has been accepted or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

[T.D. 8084, 51 FR 16305, May 2, 1986]

§ 54.4975–6 Statutory exemptions for office space or services and certain transactions involving financial institutions.

(a) *Exemption for office space or services*—(1) *In general*. Section 4975(d)(2) exempts from the excise taxes imposed by section 4975 payment by a plan to a disqualified person, including a fiduciary, for office space or any service (or a combination of services), if (i) such office space or service is necessary for the establishment or operation of the plan; (ii) such office space or service is furnished under a contract or arrangement which is reasonable; and (iii) no more than reasonable compensation is paid for such office space or service. However, section 4975(d)(2) does not contain an exemption for acts described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) or acts described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). Such acts are separate transactions not described in section 4975(d)(2). See §§ 54.4975–6(a)(5) and 54.4975–6(a)(6) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 4975(c)(1)(E).

Section 4975(d)(2) does not contain an exemption from other provisions of the Code, such as section 401, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 4975(d)(2). See, for example, the general fiduciary responsibility provisions of section 404 of the Employee Retirement Income Security Act of 1974 (the Act) (88 Stat. 877). The provisions of section 4975(d)(2) are further limited by the flush language at the end of section 4975(d) (relating to transactions with owner-employees and related persons).

(2) *Necessary service*. A service is necessary for the establishment or operation of a plan within the meaning of section 4975(d)(2) and § 54.4975–6(a)(1)(i) if the service is appropriate and helpful to the plan obtaining the service in carrying out the purposes for which the plan is established or maintained. A person providing such a service to a plan (or a person who is disqualified person solely by reason of a relationship to such a service provider described in section 4975(e)(2) (F), (G), (H), or (I)) may furnish goods which are necessary for the establishment or operation of the plan in the course of, and incidental to, the furnishing of such service to the plan.

(3) *Reasonable contract or arrangement*. No contract or arrangement is reasonable within the meaning of section 4975(d)(2) and § 54.4975–6(a)(1)(ii) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. A long-term lease which may be terminated prior to its expiration (without penalty to the plan) on reasonably short notice under the circumstances is not generally an unreasonable arrangement merely because of its long term. A provision in a contract or other arrangement which reasonably compensates the service provider or lessor for loss upon early termination of the contract, arrangement or lease is not a penalty. For example, a minimal fee in a service contract which is charged to allow recoupment of reasonable start-up costs is not a penalty.

Similarly, a provision in a lease for a termination fee that covers reasonably foreseeable expenses related to the vacancy and reletting of the office space upon early termination of the lease is not a penalty. Such a provision does not reasonably compensate for loss if it

provides for payments in excess of actual loss or if it fails to require mitigation of damages.

(4) *Reasonable compensation.* Section 4975(d)(2) and § 54.4975–6(a)(1)(iii) permit a plan to pay a disqualified person reasonable compensation for the provision of office space or services described in section 4975(d)(2). Paragraph (e) of this section contains regulations relating to what constitutes reasonable compensation for the provision of services.

(5) *Transactions with fiduciaries*—(i) *In general.* If the furnishing of office space or a service involves an act described in section 4975(c)(1) (E) or (F) (relating to acts involving conficts of interest by fiduciaries), such an act constitutes a separate transaction which is not exempt under section 4975(d)(2). The prohibitions of sections 4975(c)(1) (E) and (F) supplement the other prohibitions of section 4975(c)(1) by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries. Thus, a fiduciary may not use the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service. Nor may a fiduciary use such authority, control, or responsibility to cause a plan to enter into a transaction involving plan assets whereby such fiduciary (or a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) will receive consideration from a third party in connection with such transaction.

A person in which a fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary includes, for example, a person who is a disqualified person by reason of a relationship to such fiduciary described in section 4975(e)(2) (E), (F), (G), (H), or (I).

(ii) *Transactions not described in section 4975(c)(1)(E).* A fiduciary does not engage in an act described in section 4975(c)(1)(E) if the fiduciary does not use any of the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary. This may occur, for example, when one fiduciary is retained on behalf of a plan by a second fiduciary to provide a service for an additional fee. However, because the authority, control or responsibility which makes a person a fiduciary may be exercised ''in effect'' as well as in form, mere approval of the transaction by a second fiduciary does not mean that the first fiduciary has not used any of the authority, control or responsibility which makes such person a fiduciary to cause the plan to pay the first fiduciary an additional fee for a service.

(iii) *Services without compensation.* If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of paragraph (e)(4) of this section), the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1) (E) or (F). The allowance of a deduction to an employer under section 162 or 212 for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration.

(6) *Examples.* The provisions of § 54.4975–6(a)(5) may be illustrated by the following examples:

Example 1. E, an employer whose employees are covered by plan P, is a fiduciary or P. I is a professional investment adviser in which E has no interest which may affect the exercise of E's best judgment as a fiduciary. E causes P to retain I to provide certain kinds

of investment advisory services of a type which causes I to be a fiduciary of P under section 4975(e)(3)(B). Thereafter, I proposes to perform for additional fees portfolio evaluation services in addition to the services currently provided. The provision of such services is arranged by I and approved on behalf of the plan by E. I has not engaged in an act described in section 4975(c)(1)(E), because I did not use any of the authority, control or responsibility which makes I a fiduciary (the provision of investment advisory services) to cause the plan to pay I additional fees for the provision of the portfolio evaluation services. E has not engaged in an act which is described in section 4975(c)(1)(E). E, as the fiduciary who has the responsibility to be prudent in his selection and retention of I and the other investments advisers of the plan, has an interest in the purchase by the plan of portfolio evaluation services. However, such an interest is not an interest which may affect the exercise of E's best judgment as a fiduciary.

Example 2. D, a trustee of plan P with discretion over the management and disposition of plan assets, relies on the advice of C, a consultant to P, as to the investment of plan assets, thereby making C a fiduciary of the plan. On January 1, 1978, C recommends to D that the plan purchase an insurance policy from U, an insurance company which is not a disqualified person with respect to P. C thoroughly explains the reasons for the recommendation and makes a full disclosure concerning the fact that C will receive a commission from U upon the purchase of the policy by P. D considers the recommendation and approves the purchase of the policy by P. C receives a commission. Under such circumstances, C has engaged in an act described in section 4975(c)(1)(E) (as well as section 4975(c)(1)(F), because C is in fact exercising the authority, control or responsibility which makes C a fiduciary to cause the plan to purchase the policy. However, the transaction is exempt from the prohibited transaction provisions of section 4975(c)(1) if the requirements of Prohibited Transaction Exemption 77–9 are met.

Example 3. Assume the same facts as in Example (2) except that the nature of C's relationship with the plan is not such that C is a fiduciary of P. The purchase of the insurance policy does not involve an act described in section 4975(c)(1) (E) or (F), because such sections only apply to acts by fiduciaries.

Example 4. E, an employer whose employees are covered by plan P, is a fiduciary with respect to P. A, who is not a disqualified person with respect to P, persuades E that the plan needs the services of a professional investment adviser and that A should be hired to provide the investment advice. Accordingly, E causes P to hire A to provide investment advice of the type which makes A a fiduciary under § 54.4975–9(c)(1)(ii)(B). Prior to the expiration of A's first contract with P, A persuades E to cause P to renew A's contract with P to provide the same services for additional fees in view of the increased costs in providing such services. During the period of A's second contract, A provides additional investment advice services for which no additional charge is made. Prior to the expiration of A's second contract, A persuades E to cause P to renew his contract for additional fees in view of the additional services A is providing. A has not engaged in an act described in section 4975(c)(1)(E), because A has not used any of the authority, control or responsibility which makes A a fiduciary (the provision of investment advice) to cause the plan to pay additional fees for A's services.

Example 5. F, a trustee of plan P with discretion over the management and disposition of plan assets, retains C to provide administrative services to P of the type which makes C a fiduciary under section 4975(e)(3)(C). Thereafter, C retains F to provide, for additional fees, actuarial and various kinds of administrative services in addition to the services F is currently providing to P. Both F and C have engaged in an act described in section 4975(c)(1)(E). F, regardless of any intent which he may have had at the time he retained C, has engaged in such an act because F has, in effect, exercised the authority, control or responsibility which makes F a fiduciary to cause the plan to pay F additional fees for the services. C, whose continued employment by P depends on F, has also engaged in such an act, because C has an interest in the transaction which might affect the exercise of C's best judgment as a fiduciary. As a result, C has dealt with plan assets in his own interest under section 4975(c)(1)(E).

Example 6. F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide for a fee various kinds of administrative services necessary for the operation of the plan. F has engaged in an act described in section 4975(c)(1)(E), because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. Such act is not exempt under section 4975(d)(2) irrespective of whether the provision of the services by S is exempt.

Example 7. T, one of the trustees of plan P, is president of bank B. The bank proposes to provide administrative services to P for a fee. T physically absents himself from all consideration of B's proposal and does not otherwise exercise any of the authority, control or responsibility which makes T a fiduciary to cause the plan to retain B. The other trustees decide to retain B. T has not engaged in an act described in section 4975(c)(1)(E). Further, the other trustees have not engaged in an act described in section 4975(c)(1)(E) merely because T is on the board of trustees of P. This fact alone would

not make them have an interest in the transaction which might affect the exercise of their best judgment as fiduciaries.

(b) *Exemption for bank deposits*—(1) *In general*. Section 4975(d)(4) exempts from the excise taxes imposed by section 4975 investment of all or a part of a plan's assets in deposits bearing a reasonable rate of interest in a bank or similar financial institution supervised by the United States or a State, even though such bank or similar financial institution is a fiduciary or other disqualified person with respect to the plan, if the conditions of either § 54.4975–6(b)(2) or § 54.4975–6(b)(3) are met. Section 4975(d)(4) provides an exemption from section 4975(c)(1)(E) relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account), as well as sections 4975(c)(1) (A) through (D), because section 4975(d)(4) contemplates a bank or similar financial institution causing a plan for which it acts as a fiduciary to invest plan assets in its own deposits if the requirements of section 4975(d)(4) are met. However, it does not provide an exemption from section 4975(c)(1)(F) (relating to fidiciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). The receipt of such consideration is a separate transaction not described in the exemption. Section 4975(d)(4) does not contain an exemption from other provisions of the Code, such as section 401, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 4975(d)(4). See, for example, the general fiduciary responsibility provisions of section 404 of the Act. The provisions of section 4975(d)(4) are further limited by the flush language at the end of section 4975(d) (relating to transactions with owner-employees and related persons).

(2) *Plan covering own employees*. Such investment may be made if the plan is one which covers only the employees of the bank or similar financial institution, the employees of any of its affiliates, or the employees of both.

(3) *Other plans*—(i) *General rule*. Such investment may be made if the investment is expressly authorized by a provision of the plan or trust instrument or if the investment is expressly authorized (or made) by a fiduciary of the plan (other than the bank or similar financial institution or any of its affiliates) who has authority to make such investments, or to instruct the trustee or other fiduciary with respect to investments, and who has no interest in the transaction which may affect the exercise of such authorizing fiduciary's best judgment as a fiduciary so as to cause such authorization to constitute an act described in section 4975(c)(1) (E) or (F). Any authorization to make investments contained in a plan or trust instrument will satisfy the requirement of express authorization for investments made prior to November 1, 1977.

Effective November 1, 1977, in the case of a bank or similar financial institution that invests plan assets in deposits in itself or its affiliates under an authorization contained in a plan or trust instrument, such authorization must name such bank or similar financial institution and must state that such bank or similar financial institution may make investments in deposits which bear a reasonable rate of interest in itself (or in an affiliate.)

(ii) *Example*. B, a bank, is the trustee of plan P's assets. The trust instruments give the trustee the right to invest plan assets in its discretion. B invests in the certificates of deposit of bank C, which is a fiduciary of the plan by virtue of performing certain custodial and administrative services. The authorization is sufficient for the plan to make such investment under section 4975(d)(4). Further, such authorization would suffice to allow B to make investments in deposits in itself prior to November 1, 1977. However, subsequent to October 31, 1977, B may not invest in deposits in itself, unless the plan or trust instrument specifically authorizes it to invest in deposits of B.

(4) *Definitions*. (i) The term ''bank or similar financial institution'' includes a bank (as defined in section 581), a domestic building and loan association (as defined in section 7701(a)(19)), and a credit union (as defined in section 101 (6) of the Federal Credit Union Act).

(ii) A person is an affiliate of a bank or similar financial institution if such person and such bank or similar financial institution would be treated as members of the same controlled group of corporations or as members of two or more trades or businesses under common control within the meaning of section 414 (b) or (c) and the regulations thereunder.

(iii) The term ''deposits'' includes any account, temporary or otherwise, upon which a reasonable rate of interest is paid, including a certificate of deposit issued by a bank or similar financial institution.

(c) *Exemption for ancillary bank services*—(1) *In general.* Section 4975(d)(6) exempts from the excise taxes imposed by section 4975 the provision of certain ancillary services by a bank or similar financial institution (as defined in § 54.4975–6(b)(4)(i)) supervised by the United States or a State to a plan for which it acts as a fiduciary if the conditions in § 54.4975–6(c)(2) are met. Such ancillary services include services which do not meet the requirements of section 4975(d)(2), because the provision of such services involves an act described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) by the fiduciary bank or similar financial institution. Section 4975(d)(6) provides an exemption from section 4975(c)(1)(E), because section 4975 (d)(6) contemplates the provision of such ancillary services without the approval of a second fiduciary (as described in § 54.4975–6(a)(5)(ii)) if the conditions of § 54.4975–6(c)(2) are met. Thus, for example, plan assets held by a fiduciary bank which are reasonably expected to be needed to satisfy current plan expenses may be placed by the bank in a non-interest-bearing checking account in the bank if the conditions of § 54.4975–6(c)(2) are met, notwithstanding the provisions of section 4975(d)(4) (relating to investments in bank deposits). However, section 4975(d)(6) does not provide an exemption for an act described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). The receipt of such consideration is a separate transaction not described in section 4975(d)(6).

Section 4975(d)(6) does not contain an exemption from other provisions of the Code, such as section 401, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 4975(d)(6). See, for example, the general fiduciary responsibility provisions of section 404 of the Act. The provisions of section 4975(d)(6) are further limited by the flush language at the end of section 4975(d) (relating to transactions with owner-employees and related persons).

(2) *Conditions.* Such service must be provided:

(i) At not more than reasonable compensation;

(ii) Under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and

(iii) Only to the extent that such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of § 54.4975–6(c)(3).

(3) *Specific guidelines.* [Reserved]

(d) *Exemption for services as a fiduciary.* [Reserved]

(e) *Compensation for services*—(1) *In general.* Section 4975(d)(2) refers to the payment of reasonable compensation by a plan to a disqualified person for services rendered to the plan. Section 4975(d)(10) and §§ 54.4975–6(e)(2) through 54.4975–6(e)(5) clarify what constitutes reasonable compensation for such services.

(2) *General rule.* Generally, whether compensation is ''reasonable'' under sections 4975(d) (2) and (10) depends on the particular facts and circumstances of each case.

(3) *Payments to certain fiduciaries.* Under sections 4975(d) (2) and (10), the term ''reasonable compensation'' does not include any compensation to a fiduciary who is already receiving full-time pay from an employer or association of employers (any of whose employees are participants in the plan) or from an employee organization (any of whose members are participants in the

plan), except for the reimbursement of direct expenses properly and actually incurred and not otherwise reimbursed. The restrictions of this paragraph (e)(3) do not apply to a disqualified person who is not a fiduciary.

(4) *Certain expenses not direct expenses.* An expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead costs.

(5) *Expense advances.* Under sections 4975(d) (2) and (10), the term ''reasonable compensation'', as applied to a fiduciary or an employee of a plan, includes an advance to such a fiduciary or employee by the plan to cover direct expenses to be properly and actually incurred by such person in the performance of such person's duties with the plan if:

(i) The amount of such advance is reasonable with respect to the amount of the direct expense which is likely to be properly and actually incurred in the immediate future (such as during the next month); and

(ii) The fiduciary or employee accounts to the plan at the end of the period covered by the advance for the expenses properly and actually incurred.

(6) *Excessive compensation.* Under sections 4975(d) (2) and (10), any compensation which would be considered excessive under § 1.162–7 (relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be ''reasonable compensation''. Depending upon the facts and circumstances of the particular situation, compensation which is not excessive under § 1.162–7 may, nevertheless, not be ''reasonable compensation'' within the meaning of sections 4975(d) (2) and (10).

[T.D. 7491, 42 FR 32385, June 24, 1977; 42 FR 37810, July 25, 1977; 43 FR 4604, Feb. 3, 1978]

§ 54.4975–7 Other statutory exemptions.

(a) [Reserved]

(b) *Loans to employee stock ownership plans*—(1) *Definitions.* When used in this paragraph (b) and § 54.4975–11, the terms listed below have the following meanings:

(i) *ESOP.* The term ''ESOP'' refers to an employee stock ownership plan that meets the requirements of section 4975(e)(7) and § 54.4975–11. It is not synonymous with ''stock bonus plan.'' A stock bonus plan must, however, be an ESOP to engage in an exempt loan. The qualification of an ESOP under section 401(a) and § 54.4975–11 will not be adversely affected merely because it engages in a non-exempt loan.

(ii) *Loan.* The term ''loan'' refers to a loan made to an ESOP by a disqualified person or a loan to an ESOP which is guaranteed by a disqualified person. It includes a direct loan of cash, a purchase-money transaction, and an assumption of the obligation of an ESOP, ''Guarantee'' includes an unsecured guarantee and the use of assets of a disqualified person as collateral for a loan, even though the use of assets may not be a guarantee under applicable state law. An amendment of a loan in order to qualify as an exempt loan is not a refinancing of the loan or the making of another loan.

(iii) *Exempt loan.* The term ''exempt loan'' refers to a loan that satisfies the provisions of this paragraph (b). A ''nonexempt loan'' is one that fails to satisfy such provisions.

(iv) *Publicly traded.* The term ''publicly traded'' refers to a security that is listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) or that is quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act (15 U.S.C. 78o).

(v) *Qualifying employer security.* The term ''qualifying employer security'' refers to a security described in § 54.4975–12.

(2) *Statutory exemption*—(i) *Scope.* Section 4975(d)(3) provides an exemption from the excise tax imposed under section 4975 (a) and (b) by reason of section 4975(c)(1) (A) through (E). Section 4975(d)(3) does not provide an exemption from the imposition of such tax by reason of section 4975(c)(1)(F), relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan.

(ii) *Special scrutiny of transaction*. The exemption under section 4975(d)(3) includes within its scope certain transaction in which the potential for self-dealing by fiduciaries exists and in which the interests of fiduciaries may conflict with the interests of participants. To guard against those potential abuses, the Internal Revenue Service will subject these transactions to special scrutiny to ensure that they are primarily for the benefit of participants and their beneficiaries. Although the transactions need not be arranged and approved by an independent fiduciary, fiduciaries are cautioned to exercise scrupulously their discretion in approving them. For example, fiduciaries should be prepared to demonstrate compliance with the net effect test and the arm's-length standard under paragraph (b)(3)(ii) and (iii) of this section. Also, fiduciaries should determine that the transaction is truly arranged primarily in the interest of participants and their beneficiaries rather than, for example, in the interest of certain selling shareholders.

(3) *Primary benefit requirement*—(i) *In general*. An exempt loan must be primarily for the benefit of the ESOP participants and their beneficiaries. All the surrounding facts and circumstances, including those described in paragraph (b) (3) (ii) and (iii) of this section, will be considered in determining whether the loan satisfies this requirement. However, no loan will satisfy the requirement unless it satisfies the requirements of paragraph (b) (4), (5), and (6) of this section.

(ii) *Net effect on plan assets*. At the time that a loan is made, the interest rate for the loan and the price of securities to be acquired with the loan proceeds should not be such that plan assets might be drained off.

(iii) *Arm's-length standard*. The terms of a loan, whether or not between independent parties, must, at the same time the loan is made, be at least as favorable to the ESOP as the terms of a comparable loan resulting from arm's-length negotiations between independent parties.

(4) *Use of loan proceeds*. The proceeds of an exempt loan must be used within a reasonable time after their receipt by the borrowing ESOP only for any or all of the following purposes:

(i) To acquire qualifying employer securities.

(ii) To repay such loan.

(iii) To repay a prior exempt loan. A new loan, the proceeds of which are so used, must satisfy the provisions of this paragraph (b).

Except as provided in paragraph (b) (9) and (10) of this section or as otherwise required by applicable law, no security acquired with the proceeds of an exempt loan may be subject to a put, call, or other option, or buy-sell or similar arrangement while held by and when distributed from a plan, whether or not the plan is then an ESOP.

(5) *Liability and collateral of ESOP for loan*. An exempt loan must be without recourse against the ESOP. Furthermore, the only assets of the ESOP that may be given as collateral on an exempt loan are qualifying employer securities of two classes: those acquired with the proceeds of the loan and those that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan. No person entitled to payment under the exempt loan shall have any right to assets of the ESOP other than:

(i) Collateral given for the loan,

(ii) Contributions (other than contributions of employers securities) that are made under an ESOP to meet its obligations under the loan, and

(iii) Earnings attributable to such collateral and the investment of such contributions.

The payments made with respect to an exempt loan by the ESOP during a plan year must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years. Such contributions and earnings must be accounted for separately in the books of account of the ESOP until the loan is repaid.

(6) *Default*. In the event of default upon an exempt loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default. If the lender is a disqualified person, a loan must provide for a transfer of plan assets upon default only upon and to the extent of the failure of the plan to meet the payment schedule of

the loan. For purposes of this subparagraph (6), the making of a guarantee does not make a person a lender.

(7) *Reasonable rate of interest.* The interest rate of a loan must not be in excess of a reasonable rate of interest. All relevant factors will be considered in determining a reasonable rate of interest, including the amount and duration of the loan, the security and guarantee (if any) involved, the credit standing of the ESOP and the guarantor (if any), and the interest rate prevailing for comparable loans. When these factors are considered, a variable interest rate may be reasonable.

(8) *Release from encumbrance*—(i) *General rule.* In general, an exempt loan must provide for the release from encumbrance under this subdivision (i) of plan assets used as collateral for the loan. For each plan year during the duration of the loan, the number of securities released must equal the number of encumbered securities held immediately before release for the current plan year multiplied by a fraction. The numerator of the fraction is the amount of principal and interest paid for the year. The denominator of the fraction is the sum of the numerator plus the principal and interest to be paid for all future years. See § 54.4975–7(b) (8) (iv). The number of future years under the loan must be definitely ascertainable and must be determined without taking into account any possible extensions or renewal periods. If the interest rate under the loan is variable, the interest to be paid in future years must be computed by using the interest rate applicable as of the end of the plan year. If collateral includes more than one class of securities, the number of securities of each class to be released for a plan year must be determined by applying the same fraction to each class.

(ii) *Special rule.* A loan will not fail to be exempt merely because the number of securities to be released from encumbrance is determined solely with reference to principal payments. However, if release is determined with reference to principal payments only, the following three additional rules apply. The first rule is that the loan must provide for annual payments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments of such amounts for 10 years. The second rule is that interest included in any payment is disregarded only to the extent that it would be determined to be interest under standard loan amoritization tables. The third rule is that this subdivision, (ii) is not applicable from the time that, by reason of a renewal, extension, or refinancing, the sum of the expired duration of the exempt loan, the renewal period, the extension period, and the duration of a new exempt loan exceeds 10 years.

(iii) *Caution against plan disqualification.* Under an exempt loan, the number of securities released from encumbrance may vary from year to year. The release of securities depends upon certain employer contributions and earnings under the ESOP. Under § 54.4975–11(d)(2) actual allocations to participants' accounts are based upon assets withdrawn from the suspense account. Nevertheless, for purposes of applying the limitations under section 415 to these allocations, under § 54.4975–11(a)(8)(ii) contributions used by the ESOP to pay the loan are treated as annual additions to participants' accounts. Therefore, particular caution must be exercised to avoid exceeding the maximum annual additions under section 415. At the same time, release from encumbrance in annual varying numbers may reflect a failure on the part of the employer to make substantial and recurring contributions to the ESOP which will lead to loss of qualification under section 401(a). The Internal Revenue Service will observe closely the operation of ESOP's that release encumbered securities in varying annual amounts, particularly those that provide for the deferral of loan payments or for balloon payments.

(iv) *Illustration.* The general rule under paragraph (b)(8)(i) of this section operates as illustrated in the following example:

Example. Corporation X establishes an ESOP that borrows $750,000 from a bank. X guarantees the loan, which is for 15 years at 5% interest and is payable in level annual amounts of $72,256.72. Total payments on the loan are $1,083,850.80. The ESOP uses the entire loan proceeds to acquire 15,000 shares of X stock which is used as collateral for the loan. The number of securities to be released

for the first year is 1,000 shares, *i.e.*, 15,000 shares × $72,256.72/$1,083,850.80 = 15,000 shares × 1/15. The number of securities to be released for the second year is 1,000 shares, *i.e.*, 14,000 shares × $72,256.72/$1,011,594.08 = 14,000 shares × 1/14. If all loan payments are made as originally scheduled, the number of securities released in each succeeding year of the loan will also be 1,000.

(9) *Right of first refusal.* Qualifying employer securities acquired with proceeds of an exempt loan may, but need not, be subject to a right of first refusal. However, any such right must meet the requirements of this subparagraph (9). Securities subject to such right must be stock or an equity security, or a debt security convertible into stock or an equity security. Also, the securities must not be publicly traded at the time the right may be exercised. The right of first refusal must be in favor of the employer, the ESOP, or both in any order of priority. The selling price and other terms under the right must not be less favorable to the seller than the greater of the value of the security determined under § 54.4975–11(d)(5), or the purchase price and other terms offered by a buyer, other than the employer or the ESOP, making a good faith offer to purchase the security. The right of first refusal must lapse no later than 14 days after the security holder gives written notice to the holder of the right that an offer by a third party to purchase the security has been received.

(10) *Put option.* A qualifying employer security acquired with the proceeds of an exempt loan by an ESOP after September 30, 1976, must be subject to a put option if it is not publicly traded when distributed or if it is subject to a trading limitation when distributed. For purposes of subparagraph (10), a ''trading limitation'' on a security is a restriction under any Federal or state securities law, any regulation thereunder, or an agreement, not prohibited by this paragraph (b), affecting the security which would make the security not as freely tradable as one not subject to such restriction. The put option must be exercisable only by a participant, by the participant's donees, or by a person (including an estate or its distributee) to whom the security passes by reason of a participant's death. (Under this subparagraph (10), *participant* means a participant and beneficiaries of the participant under the ESOP.) The put option must permit a participant to put the security to the employer. Under no circumstances may the put option bind the ESOP. However, it may grant the ESOP an option to assume the rights and obligations of the employer at the time that the put option is exercised. If it is known at the time a loan is made that Federal or state law will be violated by the employer's honoring such put option, the put option must permit the security to be put, in a manner consistent with such law, to a third party (e.g., an affiliate of the employer or a shareholder other than the ESOP) that has substantial net worth at the time the loan is made and whose net worth is reasonably expected to remain substantial.

(11) *Duration of put option*—(i) *General rule.* A put option must be exercisable at least during a 15-month period which begins on the date the security subject to the put option is distributed by the ESOP.

(ii) *Special rule.* In the case of a security that is publicly traded without restriction when distributed but ceases to be so traded within 15 months after distribution, the employer must notify each security holder in writing on or before the tenth day after the date the security ceases to be so traded that for the remainder of the 15-month period the security is subject to a put option. The number of days between such tenth day and the date on which notice is actually given, if later than the tenth day, must be added to the duration of the put option. The notice must inform distributees of the terms of the put options that they are to hold. Such terms must satisfy the requirements of paragraph (b) (10) through (12) of this section.

(12) *Other put option provisions*—(i) *Manner of exercise.* A put option is exercised by the holder notifying the employer in writing that the put option is being exercised.

(ii) *Time excluded from duration of put option.* The period during which a put option is exercisable does not include any time when a distributee is unable to exercise it because the party bound by the put option is prohibited from

honoring it by applicable Federal or state law.

(iii) *Price*. The price at which a put option must be exercisable is the value of the security, determined under § 54.4975–11(d)(5).

(iv) *Payment terms*. The provisions for payment under a put option must be reasonable. The deferral of payment is reasonable if adequate security and a reasonable interest rate are provided for any credit extended and if the cumulative payments at any time are no less than the aggregate of reasonable periodic payments as of such time. Periodic payments are reasonable if annual installments, beginning with 30 days after the date the put option is excercised, are substantially equal. Generally, the payment period may not end more than 5 years after the date the put option is exercised. However, it may be extended to a date no later than the earlier of 10 years from the date the put option is exercised or the date the proceeds of the loan used by the ESOP to acquire the security subject to the put option are entirely repaid.

(v) *Payment restrictions*. Payment under a put option may be restricted by the terms of a loan, including one used to acquire a security subject to a put option made before November 1, 1977. Otherwise, payment under a put option must not be restricted by the provisions of a loan or any other arrangement, including the terms of the employer's articles of incorporation, unless so required by applicable state law.

(13) *Other terms of loan*. An exempt loan must be for a specific term. Such loan may not be payable at the demand of any person, except in the case of default.

(14) *Status of plan as ESOP*. To be exempt, a loan must be made to a plan that is an ESOP at the time of such loan. However, a loan to a plan formally designated as an ESOP at the time of the loan that fails to be an ESOP because it does not comply with section 401(a) of the Code or § 54.4975–11 will be exempt as of the time of such loan if the plan is amended retroactively under section 401(b) or § 54.4975–11(a)(4).

(15) *Special rules for certain loans*—(i) *Loans made before January 1, 1976*. A loan made before January 1, 1976, or made afterwards under a binding agreement in effect on January 1, 1976 (or under renewals permitted by the terms of the agreement on that date) is exempt for the entire period of the loan if it otherwise satisfies the provisions of this paragraph (b) for such period, even though it does not satisfy the following provisions of this section: the last sentence of paragraph (b) (4) and all of paragraph (b) (5), (6), (8) (i) and (ii), and (9) through (13), inclusive.

(ii) *Loans made after December 31, 1975, but before November 1, 1977*. A loan made after December 31, 1975, but before November 1, 1977 or made afterwards under a binding agreement in effect on November 1, 1977 (or under renewals permitted by the terms of the agreement on that date) is exempt for the entire period of the loan if it otherwise satisfies the provisions of this paragraph (b) for such period even though it does not satisfy the following provisions of this section: paragraph (b) (6) and (9) and the three additional rules listed in paragraph (b) (8) (ii).

(iii) *Release rule*. Notwithstanding paragraph (b) (15) (i) and (ii) of this section, if the proceeds of a loan are used to acquire securities after November 1, 1977, the loan must comply by such date with the provisions of paragraph (b) (8) of this section.

(iv) *Default rule*. Notwithstanding paragraph (b) (15) (i) and (ii) of this section, a loan by a disqualified person other than a guarantor must meet the requirements of paragraph (b) (6) of this section. A loan will meet these requirements if it is retroactively amended before November 1, 1977 to meet these requirements.

(v) *Put option rule*. With respect to a security distributed before November 1, 1977, the put option provisions of paragraph (b) (10), (11), and (12) of this section will be deemed satisfied as of the date the security is distributed if by December 31, 1977, the security is subject to a put option satisfying such provisions, the security is subject to a put option satisfying such provisions. For purposes of satisfying such provisions, the security will be deemed distributed on the date the put option is

issued. However, the put option provisions need not be satisfied with respect to a security that is not owned on November 1, 1977, by a person in whose hands a put option must be exercisable.

(Sec. 4975 (e) (7), (88 Stat. 976; 26 U.S.C. 4975 (e) (7)))

[T.D. 7506, 42 FR 44391, Sept. 2, 1977]

§ 54.4975–9 Definition of "fiduciary".

(a)–(b) [Reserved]

(c) *Investment advice.* (1) A person shall be deemed to be rendering ''investment advice'' to an employee benefit plan, within the meaning of section 4975(e)(3)(B) and this paragraph, only if:

(i) Such person renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; and

(ii) Such person either directly or indirectly (e.g., through or together with any affiliate):

(A) Has discretionary authority or control, whether or not pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or

(B) Renders any advice described in paragraph (c)(1)(i) of this section on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or stategy, overall portfolio composition, or diversification of plan investments.

(2) A person who is a fiduciary with respect to a plan by reason of rendering investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or having any authority or responsibility to do so, shall not be deemed to be a fiduciary regarding any assets of the plan with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice, provided that nothing in this paragraph shall be deemed to:

(i) Exempt such person from the provisions of section 405(a) of the Employee Retirement Income Security Act of 1974 concerning liability for fiduciary breaches by other fiduciaries with respect to any assets of the plan; or

(ii) Exclude such person from the definition of the term *disqualified person* (as set forth in section 4975(e)(2)) with respect to any assets of the plan.

(d) *Execution of securities transactions.* (1) A person who is a broker or dealer registered under the Securities Exchange Act of 1934, a reporting dealer who makes primary markets in securities of the United States Government or of an agency of the United States Government and reports daily to the Federal Reserve Bank of New York its positions with respect to such securities and borrowings thereon, or a bank supervised by the United States or a State, shall not be deemed to be a fiduciary, within the meaning of section 4975(e)(3), with respect to an employee benefit plan solely because such person executes transactions for the purchase or sale of securities on behalf of such plan in the ordinary course of its business as a broker, dealer, or bank, pursuant to instructions of a fiduciary with respect to such plan, if:

(i) Neither the fiduciary nor any affiliate of such fiduciary is such broker, dealer, or bank; and

(ii) The instructions specify (A) the security to be purchased or sold, (B) a price range within which such security is to be purchased or sold, or, if such security is issued by an open-end investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1, *et seq.*), a price which is determined in accordance with Rule 22c-1 under the Investment Company Act of 1940 (17 CFR 270.22c-1), (C) a time

span during which such security may be purchased or sold (not to exceed five business days), and (D) the minimum or maximum quantity of such security which may be purchased or sold within such price range, or, in the case of security issued by an open-end investment company registered under the Investment Company Act of 1940, the minimum or maximum quantity of such security which may be purchased or sold, or the value of such security in dollar amount which may be purchased or sold, at the price referred to in paragraph (d)(1)(ii)(B) of this section.

(2) A person who is a broker-dealer, reporting dealer, or bank which is a fiduciary with respect to an employee benefit plan solely by reason of the possession or exercise of discretionary authority or discretionary control in the management of the plan or the management or disposition of plan assets in connection with the execution of a transaction or transactions for the purchase or sale of securities on behalf of such plan which fails to comply with the provisions of paragraph (d)(1) of this section, shall not be deemed to be a fiduciary regarding any assets of the plan with respect to which such broker-dealer, reporting dealer or bank does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice, provided that nothing in this paragraph shall be deemed to:

(i) Exempt such broker-dealer, reporting dealer, or bank from the provisions of section 405(a) of the Employee Retirement Income Security Act of 1974 concerning liability for fiduciary breaches by other fiduciaries with respect to any assets of the plan; or

(ii) Exclude such broker-dealer, reporting dealer, or bank from the definition of the term *disqualified person* (as set forth in section 4975(e)(2)) with respect to any assets of the plan.

(e) *Affiliate and control.* (1) For purposes of paragraphs (c) and (d) of this section, an ''affiliate'' of a person shall include:

(i) Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such person;

(ii) Any officer, director, partner, employee or relative (as defined in section 4975(e)(6)) of such person; and

(iii) Any corporation or partnership of which such person is an officer, director or partner.

(2) For purposes of this paragraph, the term *control* means the power to exercise a controlling influence over the management or policies of a person other than an individual.

[T.D. 7386, 40 FR 50841, Oct. 31, 1975]

§ 54.4975–11 "ESOP" requirements.

(a) *In general*—(1) *Type of plan.* To be an ''ESOP'' (employee stock ownership plan), a plan described in section 4975(e)(7)(A) must meet the requirements of this section. See section 4975(e)(7)(B).

(2) *Designation as ESOP.* To be an ESOP, a plan must be formally designated as such in the plan document.

(3) *Continuing loan provisions under plan*—(i) *Creation of protections and rights.* The terms of an ESOP must formally provide participants with certain protections and rights with respect to plan assets acquired with the proceeds of an exempt loan. These protections and rights are those referred to in the third sentence of § 54.4975–7(b)(4), relating to put, call, or other options and to buy-sell or similar arrangements, and in § 54.4975–7(b) (10), (11), and (12), relating to put options.

(ii) *''Nonterminable'' protections and rights.* The terms of an ESOP must also formally provide that these protections and rights are nonterminable. Thus, if a plan holds or has distributed securities acquired with the proceeds of an exempt loan and either the loan is repaid or the plan ceases to be an ESOP, these protections and rights must continue to exist under the terms of the plan. However, the protections and rights will not fail to be nonterminable merely because they are not exercisable under § 54.4975–7(b) (11) and (12)(ii). For example, if, after a plan ceases to be an ESOP, securities acquired with the proceeds of an exempt loan cease to be publicly traded, the 15-month period prescribed by § 54.4975–

7(b)(11) includes the time when the securities are publicly traded.

(iii) *No incorporation by reference of protections and rights.* The formal requirements of paragraph (a)(3) (i) and (ii) of this section must be set forth in the plan. Mere reference to the third sentence of §54.4975–7(b)(4) and to the provisions of §54.4975–7(b) (10), (11), and (12) is not sufficient.

(iv) *Certain remedial amendments.* Notwithstanding the limits under paragraph (a) (4) and (10) of this section on the retroactive effect of plan amendments, a remedial plan amendment adopted before December 31, 1979, to meet the requirements of paragraph (a)(3) (i) and (ii) of this section is retroactively effective as of the later of the date on which the plan was designated as an ESOP or November 1, 1977.

(4) *Retroactive amendment.* A plan meets the requirements of this section as of the date that it is designated as an ESOP if it is amended retroactively to meet, and in fact does meet, such requirements at any of the following times:

(i) 12 months after the date on which the plan is designated as an ESOP;

(ii) 90 days after a determination letter is issued with respect to the qualification of the plan as an ESOP under this section, but only if the determination is requested by the time in paragraph (a)(4)(i) of this section; or

(iii) A later date approved by the district director.

(5) *Addition to other plan.* An ESOP may form a portion of a plan the balance of which includes a qualified pension, profit-sharing, or stock bonus plan which is not an ESOP. A reference to an ESOP includes an ESOP that forms a portion of another plan.

(6) *Conversion of existing plan to an ESOP.* If an existing pension, profit-sharing, or stock bonus plan is converted into an ESOP, the requirements of section 404 of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 877), relating to fiduciary duties, and section 401(a) of the Code, relating to requirements for plans established for the exclusive benefit of employees, applying to such conversion. A conversion may constitute a termination of an existing plan. For definition of a termination, see the regulations under section 411(d)(3) of the Code and section 4041(f) of ERISA.

(7) *Certain arrangements barred*—(i) *Buy-sell agreements.* An arrangement involving an ESOP that creates a put option must not provide for the issuance of put options other than as provided under §54.4975–7(b) (10), (11) and (12). Also, an ESOP must not otherwise obligate itself to acquire securities from a particular security holder at an indefinite time determined upon the happening of an event such as the death of the holder.

(ii) *Integrated plans.* A plan designated as an ESOP after November 1, 1977, must not be integrated directly or indirectly with contributions or benefits under title II of the Social Security Act or any other State or Federal law. ESOP's established and integrated before such date may remain integrated. However, such plans must not be amended to increase the integration level or the integration percentage. Such plans may in operation continue to increase the level of integration if under the plan such increase is limited by reference to a criterion existing apart from the plan.

(8) *Effect of certain ESOP provisions on section 401(a) status*—(i) *Exempt loan requirements.* An ESOP will not fail to meet the requirements of section 401(a)(2) merely because it gives plan assets as collateral for an exempt loan under §54.4975–7(b)(5) or uses plan assets under §54.4975–7(b)(6) to repay and exempt loan in the event of default.

(ii) *Individual annual contribution limitation.* An ESOP will not fail to meet the requirements of section 401(a)(16) merely because annual additions under section 415(c) are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to securities allocated to participants.

(iii) *Income pass-through.* An ESOP will not fail to meet the requirements of section 401(a) merely because it provides for the current payment of income under paragraph (f)(3) of this section.

(9) *Transitional rules for ESOP's established before November 1, 1977.* A plan established before November 1, 1977 that otherwise satisfies the provisions of

this section constitutes an ESOP if it is amended by December 31, 1977, to comply from November 1, 1977 with this section even though before November 1, 1977 the plan did not satisfy paragraphs (c) and (d) (2), (4), and (5) of this section.

(10) *Additional transitional rules.* Notwithstanding paragraph (a)(9) of this section, a plan established before November 1, 1977, that otherwise satisfies the provisions of this section constitutes an ESOP if by December 31, 1977, it is amended to comply from November 1, 1977, with this section even though before such date the plan did not satisfy the following provisions of this section:

(i) Paragraph (a) (3) and (8) (iii);

(ii) The last sentence of paragraph (d)(3); and

(iii) Paragraph (f)(3).

(b) *Plan designed to invest primarily in qualifying employer securities.* A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities. Thus, a stock bonus plan or a money purchase pension plan constituting an ESOP may invest part of its assets in other than qualifying employer securities. Such plan will be treated the same as other stock bonus plans or money purchase pension plans qualified under section 401a with respect to those investments.

(c) *Suspense account.* All assets acquired by an ESOP with the proceeds of an exempt loan under section 4975(d)(3) must be added to and maintained in a suspense account. They are to be withdrawn from the suspense account by applying § 54.4975–7(b) (8) and (15) as if all securities in the suspense account were encumbered. Such assets acquired before November 1, 1977, must be withdrawn by applying § 54.4975–7(b)(8) or the provision of the loan that controls release from encumbrance. Assets in such suspense accounts are assets of the ESOP. Thus, for example, such assets are subject to section 401(a)(2).

(d) *Allocations to accounts of participants*—(1) *In general.* Except as provided in this section, amounts contributed to an ESOP must be allocated as provided under § 1.401–1(b)(ii) and (iii) of this chapter, and securities acquired by an ESOP must be accounted for as provided under § 1.402(a)–1(b)(2)(ii) of this chapter.

(2) *Assets withdrawn from suspense account.* As of the end of each plan year, the ESOP must consistently allocate to the participants' accounts non-monetary units representing participants' interests in assets withdrawn from the suspense account.

(3) *Income.* Income with respect to securities acquired with the proceeds of an exempt loan must be allocated as income of the plan except to the extent that the ESOP provides for the use of income from such securities to repay the loan. Certain income may be distributed currently under paragraph (f)(3) of this section.

(4) *Forfeitures.* If a portion of a participant's account is forfeited, qualifying employer securities allocated under paragraph (d)(2) of this section must be forfeited only after other assets. If interests in more than one class of qualifying employer securities have been allocated to the participant's account, the participant must be treated as forfeiting the same proportion of each such class.

(5) *Valuation.* For purposes of § 54.4975–7(b) (9) and (12) and this section, valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities. In the case of a transaction between a plan and a disqualified person, value must be determined as of the date of the transaction. For all other purposes under this subparagraph (5), value must be determined as of the most recent valuation date under the plan. An independent appraisal will not in itself be a good faith determination of value in the case of a transaction between a plan and a disqualified person. However, in other cases, a determination of fair market value based on at least an annual appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any party to a transaction under § 54.4975–7(b) (9) and (12) will be deemed to be a good faith determination of value.

(e) *Multiple plans*—(1) *General rule.* An ESOP may not be considered together

with another plan for purposes of applying section 401(a) (4) and (5) or section 410(b) unless:

(i) The ESOP and such other plan exist on November 1, 1977, or

(ii) Paragraph (e)(2) of this section is satisfied.

(2) *Special rule for combined ESOP's.* Two or more ESOP's, one or more of which does not exist on November 1, 1977, may be considered together for purposes of applying section 401(a) (4) and (5) or section 410(b) only if the proportion of qualifying employer securities to total plan assets is substantially the same for each ESOP and:

(i) The qualifying employer securities held by all ESOP's are all of the same class; or

(ii) The ratios of each class held to all such securities held is substantially the same for each plan.

(3) *Amended coverage, contribution, or benefit structure.* For purposes of paragraph (e)(1)(i) of this section, if the coverage, contribution, or benefit structure of a plan that exists on November 1, 1977 is amended after that date, as of the effective date of the amendment, the plan is no longer considered to be a plan that exists on November 1, 1977.

(f) *Distribution*—(1) *In general.* Except as provided in paragraph (f) (2) and (3) of this section, with respect to distributions, a portion of an ESOP consisting of stock bonus plan or a money purchase pension plan is not to be distinguished from other such plans under section 401(a). Thus, for example, benefits distributable from the portion of an ESOP consisting of a stock bonus plan are distributable only in stock of the employer. Also, benefits distributable from the money-purchase portion of the ESOP may be, but are not required to be, distributable in qualifying employer securities.

(2) *Exempt loan proceeds.* If securities acquired with the proceeds of an exempt loan available for distribution consist of more than one class, a distributee must receive substantially the same proportion of each such class. However, as indicated in paragraph (f)(1) of this section, benefits distributable from the portion of an ESOP consisting of a stock bonus plan are distributable only in stock of the employer.

(3) *Income.* Income paid with respect to qualifying employer securities acquired by an ESOP in taxable years beginning after December 31, 1974, may be distributed at any time after receipt by the plan to participants on whose behalf such securities have been allocated. However, under an ESOP that is a stock bonus plan, income held by the plan for a 2-year period or longer must be distributed under the general rules described in paragraph (f)(1) of this section. (See the last sentence of section 803(h), Tax Reform Act of 1976.)

(Sec. 4975(e)(7), (88 Stat. 976; 26 U.S.C. 4975(e)(7)))

[T.D. 7506, 42 FR 44393, Sept. 2, 1977, as amended by T.D. 7571, 44 FR 1978, Jan. 9, 1979]

§ 54.4975–12 Definition of the term "qualifying employer security".

(a) *In general.* For purposes of section 4975(e)(8) and this section, the term ''qualifying employer security'' means an employer security which is:

(1) Stock or otherwise an equity security, or

(2) A bond, debenture, note, or certificate or other evidence of indebtedness which is described in paragraphs (1), (2), and (3) of section 503(e).

(b) *Special rule.* In determining whether a bond, debenture, note, or certificate or other evidence of indebtedness is described in paragraphs (1), (2), and (3) of section 503(e), any organization described in section 401(a) shall be treated as an organization subject to the provisions of section 503.

(Sec. 4975(e)(7) (88 Stat. 976; 26 U.S.C. 4975(e)(7)))

[T.D. 7506, 42 FR 44394, Sept. 2, 1977]

§ 54.4975–14 Election to pay an excise tax for certain pre-1975 prohibited transactions.

(a) *In general.* Section 2003(c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) provides an election to pay an excise tax by certain persons involved prior to 1975 in prohibited transactions within the meaning of section 503 (b) or (g).

(b) *Effect of election.* If a valid election is made under this section with respect to a particular transaction, any

loss of exemption under section 501(a) because of a prohibited transaction within the meaning of section 503 (b) or (g) shall not apply. Instead, the person who made the election referred to in this section shall be subject to the taxes which would have been imposed by section 4975 (a) or (b) as though section 4975 had imposed a tax in respect of the transaction. (However, section 4975(f)(1), relating to joint and several liability, shall not apply to any person who has not made an election under this section, and interest for late payment of tax shall not begin to accrue until after the date of the election.) Such an election is irrevocable. However, the making of the election does not affect the application of section 6501 for purposes of assessment and collection of tax and section 6511 for purposes of filing a claim for credit or refund with respect to taxpayers and to taxable years of taxpayers whose tax liability is or may be affected by reason of the nonapplication of a denial of exempt status.

(c) *Method of election*. A person shall make the election referred to in this section by filing the form issued for such purpose by the Internal Revenue Service, including therein the information required by such form and the instructions issued with respect thereto, and by paying the tax which the taxpayer indicates is due at the time the return is filed. To be valid the election must be made prior to the later of December 6, 1976, or 120 days after the date of notification referred to in § 1.503(a)–1(b) of this chapter (Income Tax Regulations), relating to loss of exemption for certain prohibited transactions. If there has been no notification of loss of exemption, the election may be made at any time. However, these limitations do not preclude an agreement between the disqualified person and the district director to extend the time within which the election is permitted.

(d) *Computation of section 4975 excise tax*. To the extent applicable, and solely for purposes associated with the payment of a section 4975 excise tax under the election referred to in this section, § 53.4941(e)–1 of this chapter (Foundation Excise Tax Regulations) is controlling.

(Sec. 2003(c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978))

[T.D. 7489, 42 FR 27882, June 1, 1977]

§ 54.4975–15 Other transitional rules.

(a)–(c) [Reserved]

(d) *Provision of certain services until June 30, 1977*—(1) *In general*. Section 2003(c)(2)(D) of the Employee Retirement Income Security Act of 1974 (the Act) (88 Stat. 979) provides that section 4975 shall not apply to the provision of services before June 30, 1977, between a plan and a disqualified person if the three requirements contained in section 2003(c)(2)(D) of the Act are met. The first requirement is that such services must be provided either (in) under a binding contract in effect on July 1, 1974 (or pursuant to a renewal or modification of such contract); or (ii) by a disqualified person who ordinarily and customarily furnished such services on June 30, 1974. The second requirement is that the services be provided on terms that remain at least as favorable to the plan as an arm's-length transaction with an unrelated party would be.

For this purpose, such services are provided on terms that remain at least as favorable to the plan as an arms-length transaction with an unrelated party would be if, at the time of execution (or renewal) of such binding contract, the contract (or renewal) is on terms at least as favorable to the plan as an arm's-length transaction with an unrelated party would be. However, if in a normal commercial setting an unrelated party in the position of the plan could be expected to insist upon a renegotiation or termination of a binding contract, the plan must so act. Thus, for example, if a disqualified person provides services to a plan on a month-to-month basis, and a party in the position of the plan could be expected to renegotiate the price paid under such contract because of a decline in the fair market value of such services, the plan must so act in order to avoid participation in a prohibited transaction. The third requirement is that the provision of services must not be, or have

been, at the time of such provision a prohibited transaction within the meaning of section 503(b) or the corresponding provisions of prior law. If these three requirements are met, section 4975 will apply neither to services provided before June 30, 1977 (both to customers to whom such services were being provided on June 30, 1974, and to new customers) nor to the receipt of compensation therefor. Thus, if these three requirements are met, section 4975 will not apply until June 30, 1977, to the provision of services to a plan by a disqualified person (including a fiduciary) even if such services could not be furnished pursuant to the exemption provisions of sections 4975(d)(2) or (6) and §54.4975–6. For example, if the three requirements of section 2003(c)(2)(D) of the Act are met, a person serving as fiduciary to a plan who already receives full-time pay from an employer or an association of employers, whose employees are participants in such plan, or from an employee organization whose members are participants in such plan, may continue to receive reasonable compensation from the plan for services rendered to the plan before June 30, 1977. Similarly, until June 30, 1977, a plan consultant who may be a fiduciary because of the nature of the consultative and administrative services being provided may, if these three requirements are met, continue to cause the sale of insurance to the plan and continue to receive commissions for such sales from the insurance company writing the policy. Further, if the three requirements of section 2003 (c)(2)(D) of the Act are met, a securities broker dealer who renders investment advice to a plan for a fee, thereby becoming a fiduciary may furnish other services to the plan, such as brokerage services, and receives compensation therefor. Also, if a registered representative of such a broker-dealer were a fiduciary, the registered representative may receive compensation, including commissions, for brokerage services performed before June 30, 1977.

(2) *Persons deemed to be June 30, 1974, service providers.* A disqualified person with respect to a plan which did not, on June 30, 1974, ordinarily and customarily furnish a particular service, will nevertheless be considered to have ordinarily and customarily furnished such service on June 30, 1974, for purposes of this section and section 2003(c)(2)(D) of the Act, if either of the following conditions are met:

(i) At least 50 percent of the outstanding beneficial interests of such disqualified person are owned directly or through one or more intermediaries by the same person or persons who owned, directly or through one or more intermediaries, at least 50 percent of the outstanding beneficial interests of a person who ordinarily and customarily furnished such service on June 30, 1974; or

(ii) Control, or the power to exercise a controlling influence over the management and policies of such disqualified person is possessed, directly or through one or more intermediaries, by the same person or persons who possessed directly or through one or more intermediaries control, or the power to exercise a controlling influence over the management and policies of a person who ordinarily and customarily furnished such service on June 30, 1974. For purposes of this paragraph (d)(2) a person shall be deemed to be an ''intermediary'' of another person if at least 50 percent of the outstanding beneficial interests of such person are owned by such other person, directly or indirectly, or if such other person controls or has the power to exercise a controlling influence over the management and policies of such person.

(3) *Examples.* The principals of §54.4975–15(d)(2) may be illustrated by the following examples.

Example 1. A owns 50 percent of the outstanding beneficial interests of ABC Partnership which ordinarily and customarily furnished certain services on June 30, 1974. On July 2, 1974, ABC Partnership was incorporated into ABC Corporation with one class of stock outstanding. A owns 50 percent of the shares of such stock. ABC Corporation furnishes the same services that were furnished by ABC Partnership on June 30, 1974. ABC Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example 2. A and B together own 100 percent of the beneficial interests of AB Partnership, which ordinarily and customarily furnished certain services on June 30, 1974. On September 1, 1974, AB Partnership was incorporated into AB Corporation with one

class of stock outstanding. A and B each own 20 percent of such outstanding class of stock and together have control over the management and policies of AB Corporation. AB Corporation furnishes the same services that were furnished by AB Partnership on June 30, 1974. AB Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example 3. On June 30, 1974, M Corporation was ordinarily and customarily furnishing certain services. On that date, X, Y and Z together owned 50 percent of all classes of the outstanding shares of M Corporation. On January 28, 1975, all of the shareholders of M Corporation exchanged their shares in M Corporation for shares of a new N Corporation. As a result of that exchange, X, Y and Z together own 50 percent of the common stock of N Corporation, the only class of N Corporation stock outstanding after the exchange. N Corporation furnishes the services formerly furnished by M Corporation. N Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example 4. I Corporation ordinarily and customarily furnished certain services on June 30, 1974. On November 3, 1975, I Corporation organizes a wholly owned subsidiary, S Corporation, which furnishes the same services ordinarily and customarily furnished by I Corporation on June 30, 1974. S Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example 5. X Corporation, wholly-owned and controlled by A, ordinarily and customarily furnished certain services on June 30, 1974. Y Corporation did not perform such services on that date. On January 2, 1976, X Corporation is merged into Y Corporation and although A received less than 50 percent of the total outstanding shares of Y Corporation, after such merger A has control over the management and policies of Y Corporation. Y Corporation furnishes the same services that were formerly furnished by X Corporation. Y Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

[T.D. 7491, 42 FR 32388, June 24, 1977]

§ 54.4976–1T Questions and answers relating to taxes with respect to welfare benefit funds (temporary).

Q–1: What does section 4976 provide?

A–1: Section 4976 imposes a tax on employers who provide disqualified benefits through a welfare benefit fund. The tax imposed is equal to 100 percent of the disqualified benefit.

Q–2: What constitutes a disqualified benefit?

A–2: A disqualified benefit is (a) any post-retirement medical or life insurance benefit provided with respect to a key employee (as defined in section 419A(d)(3)) through a welfare benefit fund if a separate account is required to be established for such employee under section 419A(d) and the cost for such coverage is not charged against or paid from such separate account; (b) any post-retirement medical or life insurance benefit provided through a welfare benefit fund with respect to an individual in whose favor discrimination is prohibited unless the plan of which the fund is a part meets the requirements of section 505(b) with respect to that benefit; and (c) any portion of the fund which reverts to the benefit of the employer. A post-retirement medical or life insurance benefit provided with respect to a key employee will not constitute a disqualified benefit even though such benefit is not provided through a separate account if the cost of such benefit is paid by the employer in the taxable year in which the benefit is provided and there is not (and there is not required to be) a separate account with an outstanding credit balance maintained for the key employee.

Q–3: What is the effective date of section 4976?

A–3: (a) Generally, section 4976 applies to disqualified benefits provided by a welfare benefit fund after December 31, 1985. However, a disqualified benefit, as defined in section 4976(b)(1) or (2), is not subject to section 4976(a) if it is provided from ''existing reserves for post-retirement medical or life insurance benefits'' that are within the transition rule set forth in section 512(a)(3)(E)(iii) and Q&A–4 of § 1.512(a)–5T (or would be if such transition rule applied to such welfare benefit fund). For example, if a welfare benefit fund in existence on July 18, 1984, provides an individual in whose favor discrimination is prohibited with a post-retirement life insurance benefit after December 31, 1985, that does not meet the requirements of section 505(b) and if the welfare benefit fund received no contributions after July 18, 1984, then

the disqualified benefit provided by the fund is not subject to section 4976(a)

(b) A welfare benefit fund will be able to avoid the application of section 4976(b)(1) and (2) if the employer withdraws from such fund, before April 7, 1986, any amounts that are not attributable to ''existing reserves for post-retirement medical or life insurance benefits'' because they were neither actually set aside nor treated as actually set aside under Q&A–4 of §1.512(a)–5T, on July 18, 1984. The employer making such a withdrawal must include the amount in income for the first taxable year ending after July 18, 1984, or, to the extent that the withdrawn amount is attributable to the following taxable year, for such following taxable year. Such a withdrawal will not be treated as an impermissible distribution or reversion under section 501(c)(9), and will not be treated as a disqualified benefit under section 4976(b)(3). Of course, to the extent that the welfare benefit fund contains amounts that are attributable to ''existing reserves'' but are not within the transition rule set forth in Q&A–4 of §1.512(a)–5T (as applied to welfare benefit funds), for example, because such amounts exceed the amounts that could have been accumulated under the principles set forth in Revenue Rulings 69–382, 1969–2 C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40, the fund will not be able to avoid the application of section 4976(b)(1) and (2) under this paragraph.

(c) In the case of a plan which is maintained pursuant to one or more collective bargaining agreements (1) between employee representatives and one or more employers and (2) which are in effect on July 1, 1985 (or ratified on or before that date), the provision does not apply to disqualified benefits provided in years beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension of the contract agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act 1984 (*i.e.*, requirements under sections 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreement.

[T.D. 8073, 51 FR 4336, Feb. 4, 1986]

§54.4977–1T Questions and answers relating to the election concerning lines of business in existence on January 1, 1984 (temporary).

The following questions and answers relate to the election by employers under section 4977 of the Internal Revenue Code of 1954, as added by section 531(e)(1) of the Tax Reform Act of 1984 (98 Stat. 886), to treat all employees of any line of business in existence on January 1, 1984, as employees of one of those lines of business for purposes of section 132(a) (1) and (2):

Q–1: What does section 4977 provide with respect to the exclusion from gross income of certain fringe benefits?

A–1: In general, section 4977 provides an elective grandfather rule that allows an employer under certain circumstances to treat employees of all lines of business which were in existence on January 1, 1984, as employees of one of those lines of business for purposes of section 132(a) (1) and (2), but not for purposes of section 132(g)(2).

Q–2: Under what circumstances does the elective grandfather rule of section 4977 apply?

A–2: If:

(a) An election under section 4977 is in effect with respect to an employer for any calendar year, and

(b) On and after January 1, 1984, at least 85 percent of the employees of the employer in all of its lines of business which existed on January 1, 1984, were entitled to employee discounts or services provided by the employer in one line of business,

then all employees of any line of business of the employer which was in existence on January 1, 1984, are treated, for purposes of section 132(a) (1) and (2) (but not for purposes of section 132(g)(2)) as employees of the one line of business referred to in (b) of this Q/A–2.

Q–3: How does an employer make the election provided for in section 4977?

A–3: An employer must file a statement with the director of the service center with which the employer's tax

returns are filed. The statement must indicate that the employer is electing to apply the provisions of section 4977 to one or more of the employer's lines of business and must contain the following information:

(a) The employer's name, address, and taxpayer identification number;

(b) A description of all of the employer's lines of business in existence on January 1, 1984; and

(c) For each lines of business which is to have as an employee for purposes of section 132(a) (1) and (2) an individual but for the election under section 4977 would not be treated as an employee for purposes of section 132(a) (1) and (2):

(1) A description of the no-additional-cost service or qualified employee discount (including, with respect to discounts, the percentage discount) to be offered to employees pursuant to section 4977 in such line of business, and

(2) With respect to employees in all of the employer's lines of business in existence on January 1, 1984, the number of such employees and the number entitled to the described fringe benefit. Such numbers may be determined as of a date which does not precede the date the election is filed by more than 30 days.

Q–4: In order to make a timely section 4977 election, when must an employer file the election statement?

A–4: Except as otherwise provided in the second sentence of this answer, the employer must file the election statement before the end of the calendar year preceding the year for which the election is to apply. For calendar year 1985, however, the employer has until March 31, 1985, to file the election statement. However, the Commissioner may, in his discretion, extend the March 31, 1985 deadline to a later date.

Q–5: Does section 4977 apply to all calendar years following the calendar year in which the election is made?

A–5: Yes, unless the employer revokes the election.

Q–6: When is a revocation effective?

A–6: A revocation is effective with respect to the calendar year following the calendar year in which it is filed.

Q–7: If an employer does not make a timely section 4977 election with respect to 1985, will the employer be entitled to make an election with respect to any subsequent year?

A–7: No.

Q–8: If an employer revokes a section 4977 election, is the employer entitled to elect the application of section 4977 for subsequent years?

A–8: No.

[T.D. 8004, 50 FR 758, Jan. 7, 1985]

§ 54.4978–1T Questions and answers relating to the tax on certain dispositions by employee stock ownership plans and certain cooperatives (temporary).

Q–1: What does section 4978 provide?

A–1: Section 4978 imposes a tax (as determined under section 4978(b) and Q&A–2 of this section) on the amount realized on the disposition of any qualified securities, if:

(a) An employee stock ownership plan or eligible worker-owned cooperative acquires any qualified securities in a sale to which section 1042 applies;

(b) Such plan or cooperative disposes of any qualified securities during the 3-year period after the date on which any qualified securities were acquired in the sale to which section 1042 applies; and

(c) Either (1) the percentage of the total outstanding shares of the class of employer securities of which the disposed qualified securities are a part held by such plan or cooperative after such disposition is less than the percentage of the total outstanding shares of such class of employer securities held immediately after the sale to which section 1042 applies, or (2) the value of the employer securities held by such plan or cooperative immediately after such disposition is less than 30 percent of the total value of all employer securities outstanding at that time. For purposes of this section, the following terms have the same meanings given to such terms by the identified provisions: ''employee stock ownership plan'' (section 4975(e)(7)); ''qualified securities'' (section 1042(b)(1)); ''eligible worker-owned cooperative'' (section 1042(b)(2)); ''employer securities'' (section 409(l)). For purposes of determining what constitutes a disposition to which section 4978 applies, see Q&A–3 of this section.

Q–2: What is the amount of tax imposed under section 4978?

A–2: Section 4978 imposes a tax of 10 percent of the amount realized on the disposition of qualified securities. The amount realized that is subject to tax under section 4978 shall not exceed that portion of the amount realized that is allocable to qualified securities acquired within the 3-year period prior to the date of disposition and to which section 1042 applied (''restricted qualified securities''). In determining the amount realized (except as otherwise provided in Q&A–3 of this section), any disposition of employer securities with respect to which the condition contained in provision (c) of Q&A–1 is met shall be treated, first, as a disposition of restricted qualified securities (on a first in, first out basis) and, thereafter, as a disposition of any other employer securities. Thus, for example, if a plan disposes of more employer securities than the number of restricted qualified securities held by the plan at that time and immediately after such disposition the value of the employer securities held by the plan is less than 30 percent of the total value of all outstanding employer securities, the portion of the total amount realized that is allocable to restricted qualified securities subject to tax under section 4978 is determined by multiplying the total amount realized on the disposition by a fraction, the numerator of which is the total value of restricted qualified securities included in the disposition and the denominator of which is the total value of employer securities in the disposition.

Q–3: What constitutes a ''disposition'' under section 4978?

A–3: (a) Under section 4978, the term ''disposition'' includes any sale, exchange, or distribution. However, in the case of any exchange of qualified securities for stock of another corporation in any reorganization described in section 368(a)(1), such exchange shall not be treated as a disposition for purposes of section 4978.

(b) Section 4978 shall not apply to any disposition of qualified securites which is made by reason of:

(1) The death of the employee;

(2) The retirement of the employee after the employee has attained 59½ years of age;

(3) The disability of the employee (within the meaning of section 72(m)(5)); or

(4) The separation of the employee from service for any period which results in a 1-year break in service (within the meaning of section 411(a)(6)(A)).

Any disposition of employer securities within this paragraph and any disposition of employer securities with respect to which the condition contained in provision (c) of Q&A–1 of this section is not met shall be treated, first, as a disposition of securities that are not restricted qualified securities and, thereafter, as a disposition of restricted qualified securities (on a first-in, first-out basis).

(c) If restricted qualified securities held by an employee stock ownership plan or eligible worker-owned cooperative no longer meet the definition of qualified securities (''old restricted qualified securities'') as a result of a transaction changing (1) the status of a corporation as an employer, or as a member of a controlled group of corporations including the employer, or (2) the existence of employer securities of the type described in section 409(l)(1), the disposition of such securities shall not be treated as a disposition of restricted qualified securites to which the tax under section 4978 is imposed if, within 90 days after such disposition, securities meeting the requirements of section 409(l) (''new restricted qualified securities'') that are of equal value to the old restricted qualfied securities (at the time of the disposition of the old restricted qualified securities) are substituted for such old restricted qualified securities. However, for purposes of determining the tax imposed under section 4978, old restricted qualified securities shall not be treated as if they retained their status as restricted qualified securities and new restricted qualified securities derived from the disposition of old restricted qualified securities pursuant to the preceding sentence shall be treated as restricted qualified securities for the remaining portion of the period during which the disposition of the old restricted qualified securities

would have been subject to tax under section 4978.

Q–4: To whom does the tax under section 4978 apply?

A–4: The tax under section 4978 is imposed on the domestic corporation (or corporations) or the eligible worker-owned cooperative that made the written statement of consent as described in section 1042(a)(2)(B) and Q&A–2 of § 1.1042–1T with respect to the disposition of the restricted qualified securities.

Q–5: When does section 4978, as enacted by the Tax Reform Act of 1984, become effective?

A–5: Section 4978 applies to the disposition of qualified securities acquired in a sale to which section 1042 applies. See Q&A–6 of § 1.1042–1T for the effective date of section 1042.

[T.D. 8073, 51 FR 4336, Feb. 4, 1986]

§ 54.4979–0 Excise tax on certain excess contributions and excess aggregate contributions; table of contents.

This section contains the captions that appear in § 54.4979.

§ 54.4979–1 Excise tax on certain excess contributions and excess aggregate contributions.

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[T.D. 8357, 56 FR 40550, Aug. 15, 1991; 57 FR 10290, Mar. 25, 1992, as amended by T.D. 8581, 59 FR 66181, Dec. 23, 1994]

§ 54.4979–1 Excise tax on certain excess contributions and excess aggregate contributions.

(a) *In general*—(1) *General rule*. In the case of any plan (as defined in paragraph (b)(3) of this section), there is imposed a tax for the employer's taxable year equal to 10 percent of the sum of:

(i) Any excess contributions under a plan for the plan year ending in the taxable year; and

(ii) Any excess aggregate contributions under the plan for the plan year ending in the taxable year.

(2) *Liability for tax*. The tax imposed by paragraph (a)(1) of this section is to be paid by the employer. In the case of a collectively bargained plan to which section 413(b) applies, all employers who are parties to the collective bargaining agreement and whose employees are participants in the plan are jointly and severally liable for the tax.

(3) *Due date and form for payment of tax*—(i) The tax described in paragraph (a)(1) of this section is due on the last day of the 15th month after the close of the plan year to which the excess contributions or excess aggregate contributions relate.

(ii) An employer that owes the tax described in paragraph (a)(1) of this section must file the form prescribed by the Commissioner for the payment of the tax.

(4) *Special rule for simplified employee pensions*—(i) An employer that maintains a simplified employee pension (SEP) as defined in section 408(k) that accepts elective contributions is exempted from the tax of section 4979 and paragraph (a)(1) of this section if it notifies its employees of the fact and tax consequences of excess contributions within 2½ months following the plan year for which excess contributions are made. The notification must meet the standards of paragraph (a)(4)(ii) of this section.

(ii) The employer's notification to each affected employee of the excess SEP contributions must specifically state, in a manner calculated to be understood by the average plan participant: the amount of the excess contributions attributable to that employee's elective deferrals; the calendar year for which the excess contributions

were made; that the excess contributions are includible in the affected employee's gross income for the specified calendar year; and that failure to withdraw the excess contributions and income attributable thereto by the due date (plus extensions) for filing the affected employee's tax return for the preceding calendar year may result in significant penalties.

(iii) If an employer does not notify its employees by the last day of the 12-month period following the year of excess SEP contributions, the SEP will no longer be considered to meet the requirements of section 408(k)(6).

(b) *Definitions.* The following is a list of terms and definitions to be used for purposes of section 4979 and this section:

(1) *Excess aggregate contributions.* The term ''excess aggregate contribution'' has the meaning set forth in § 1.401(m)–5 of this chapter. For purposes of determining excess aggregate contributions under an annuity contract described in section 403(b), the contract is treated as a plan described in section 401(a).

(2) *Excess contributions.* The term ''excess contributions'' has the meaning set forth in sections 401(k)(8)(B), 408(k)(6)(C)(ii), and 501(c)(18). See, e.g., § 1.401(k)–6 of this chapter.

(3) *Plan.* The term ''plan'' means:

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

(ii) Any annuity plan described in section 403(a);

(iii) Any annuity contract described in section 403(b);

(iv) A simplified employee pension of an employer that satisfies the requirements of section 408(k); and

(v) A plan described in section 501(c)(18).

The term includes any plan that at any time has been determined by the Secretary to be one of the types of plans described in this paragraph (b)(3).

(c) *No tax when excess distributed within 2½ months of close of year or additional employer contributions made*—(1) *General rule.* No tax is imposed under this section on any excess contribution or excess aggregate contribution, as the case may be, to the extent the contribution (together with any income allocable thereto) is corrected before the close of the first 2½ months of the following plan year (6 months in the case of a plan that includes an eligible automatic contribution arrangement within the meaning of section 414(w)). The extension to 6 months applies to a distribution of excess contributions or excess aggregate contributions for a plan year beginning on or after January 1, 2010, only where all the eligible NHCEs and eligible HCEs (both as defined in § 1.401(k)–6 of this Chapter) are covered employees under an eligible automatic contribution arrangement within the meaning of section 414(w) for the entire plan year (or the portion of the plan year that the eligible NHCEs and eligible HCEs are eligible employees under the plan)). Qualified nonelective contributions and qualified matching contributions taken into account under § 1.401(k)–2(a)(6) of this Chapter or qualified nonelective contributions or elective contributions taken into account under § 1.401(m)–2(a)(6) of this Chapter for a plan year may permit a plan to avoid excess contributions or excess aggregate contributions, respectively, even if made after the close of the 2½ month (or 6 month) period for distributing excess contributions or excess aggregate contributions without the excise tax. See § 1.401(k)–2(b)(1)(i) and (5)(i) of this Chapter for methods to avoid excess contributions, and § 1.401(m)–2(b)(1)(i) of the Chapter for methods to avoid excess aggregate contributions.

(2) *Tax treatment of distributions.* See § 1.401(k)–2(b)(3)(ii) and (2)(vi) of this chapter for rules for determining the tax consequences to a participant of a distribution or recharacterization of excess contributions and income allocable thereto, including a special rule for de minimis distributions. See § 1.401(m)–2(b)(2)(vi) of this chapter for rules for determining the tax consequences to a participant of a distribution of excess aggregate contributions and income allocable thereto.

EDITORIAL NOTE: By T.D. 9169, 69 FR 78154, Dec. 29, 2005, § 54.4979–1 was amended in paragraph (c)(2) by removing ''1.401(k)–1(f)(1)(i) and (6)(i)'' and replacing it with ''1.401(k)–2(b)(1)(i) and (6)(i)''. However, this text does not exist in paragraph (c)(2) so the amendment could not be done.

(3) *Income*. See § 1.401(k)–2(b)(2)(iv) of this chapter for rules for determining income allocable to excess contributions. See § 1.401(m)–2(b)(2)(iv) of this chapter for rules for determining income allocable to excess aggregate contributions.

(4) *Example*. The provisions of this paragraph (c) are illustrated by the following example.

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under the plan, failure to satisfy the actual deferral percentage test may only be corrected by distributing the excess contributions or making qualified nonelective contributions (QNECs).

(ii) On December 31, 1990, X determines that Y does not satisfy the actual deferral percentage test for the 1990 plan year, and that excess contributions for the year equal $5,000. On March 1, 1991, Y distributes $2,000 of these excess contributions. On May 30, 1991, X distributes another $2,000 of excess contributions. On December 17, 1991, X contributes QNECs for certain nonhighly compensated employees, thereby eliminating the remainder of the excess contributions for 1990.

(iii) X has incurred a tax liability under section 4979 for 1990 equal to 10 percent of the excess contributions that were in the plan as of December 31, 1990. However, this tax is not imposed on the $2,000 distributed on March 1, 1991, or the amount corrected by QNECs. X must pay an excise tax of $200, 10 percent of the $2,000 of excess contributions distributed after March 15, 1991. This tax must be paid by March 31, 1992.

(d) *Effective date*—(1) *General rule*. Except as provided in paragraphs (d)(2) through (4), this section is effective for plan years beginning after December 31, 1986.

(2) *Section 403(b) annuity contracts*. In the case of an annuity contract under section 403(b), this section applies to plan years beginning after December 31, 1988.

(3) *Collectively bargained plans and plans of state or local governments*. For plan years beginning before January 1, 1993, the provisions of this section do not apply to a collectively bargained plan that automatically satisfies the requirements of section 410(b). See §§ 1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7) of this chapter. In the case of a plan (including a collectively bargained plan) maintained by a state or local government, the provisions of this section do not apply for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. For purposes of this paragraph (d)(3), the term *governing body with authority to amend the plan* means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(4) *Plan years beginning before January 1, 1992*. For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in section 4979, as in effect during those years, may be relied upon in determining whether the excise tax is due for those years.

[T.D. 8357, 56 FR 40550, Aug. 15, 1991, as amended by T.D. 8581, 59 FR 66181, Dec. 23, 1994; T.D. 9169, 69 FR 78153, Dec. 29, 2004; T.D. 9447, 74 FR 8214, Feb. 24, 2009]

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§ 54.4980B–10 Interaction of FMLA and COBRA.

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[T.D. 8812, 64 FR 5173, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1848, Jan. 10, 2001; T.D. 9457, 74 FR 45997, Sept. 8, 2009]

§ 54.4980B–1 COBRA in general.

The COBRA continuation coverage requirements are described in general in the following questions-and-answers:

Q–1: What are the health care continuation coverage requirements contained in section 4980B of the Internal Revenue Code and in ERISA?

A–1: (a) Section 4980B provides generally that a group health plan must offer each qualified beneficiary who would otherwise lose coverage under the plan as a result of a qualifying event an opportunity to elect, within the election period, continuation coverage under the plan. The continuation coverage requirements were added to section 162 by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Public Law 99–272 (100 Stat. 222), and moved to section 4980B by the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3342). Continuation coverage required under section 4980B is referred to in §§ 54.4980B–1 through 54.4980B–10 as COBRA continuation coverage.

(b) COBRA also added parallel continuation coverage requirements to Part 6 of Subtitle B of Title I of the Employee Retirement Income Security Act of 1974 (ERISA) (29 U.S.C. 1161–1168), which is administered by the U.S. Department of Labor. If a plan does not comply with the COBRA continuation

coverage requirements, the Internal Revenue Code imposes an excise tax on the employer maintaining the plan (or on the plan itself), whereas ERISA gives certain parties—including qualified beneficiaries who are participants or beneficiaries within the meaning of Title I of ERISA, as well as the Department of Labor—the right to file a lawsuit to redress the noncompliance. The rules in §§ 54.4980B–1 through 54.4980B–10 apply for purposes of section 4980B and generally also for purposes of the COBRA continuation coverage requirements in Title I of ERISA. However, certain provisions of the COBRA continuation coverage requirements (such as the definitions of group health plan, employee, and employer) are not identical in the Internal Revenue Code and Title I of ERISA. In those cases in which the statutory language is not identical, the rules in §§ 54.4980B–1 through 54.4980B–10 nonetheless apply to the COBRA continuation coverage requirements of Title I of ERISA, except to the extent those rules are inconsistent with the statutory language of Title I of ERISA.

(c) A group health plan that is subject to section 4980B (or the parallel provisions under ERISA) is referred to as being subject to COBRA. (See Q&A–4 of § 54.4980B–2). A qualified beneficiary can be required to pay for COBRA continuation coverage. The term *qualified beneficiary* is defined in Q&A–1 of § 54.4980B–3. The term *qualifying event* is defined in Q&A–1 of § 54.4980B–4. COBRA continuation coverage is described in § 54.4980B–5. The election procedures are described in § 54.4980B–6. Duration of COBRA continuation coverage is addressed in § 54.4980B–7, and payment for COBRA continuation coverage is addressed in § 54.4980B–8. Section 54.4980B–9 contains special rules for how COBRA applies in connection with business reorganizations and employer withdrawals from a multiemployer plan, and § 54.4980B–10 addresses how COBRA applies for individuals who take leave under the Family and Medical Leave Act of 1993. Unless the context indicates otherwise, any reference in §§ 54.4980B–1 through 54.4980B–10 to COBRA refers to section 4980B (as amended) and to the parallel provisions of ERISA.

Q–2: What standard applies for topics not addressed in §§ 54.4980B–1 through 54.4980B-10?

A–2: For purposes of section 4980B, for topics relating to the COBRA continuation coverage requirements of section 4980B that are not addressed in §§ 54.4980B–1 through 54.4980B–10 (such as methods for calculating the applicable premium), plans and employers must operate in good faith compliance with a reasonable interpretation of the statutory requirements in section 4980B.

[T.D. 8812, 64 FR 5173, Feb 3, 1999; 64 FR 14382, Mar. 25, 1999, as amended by T.D. 8928, 66 FR 1849, Jan. 10, 2001]

§ 54.4980B–2 Plans that must comply.

The following questions-and-answers apply in determining which plans must comply with the COBRA continuation coverage requirements:

Q–1: For purposes of section 4980B, what is a group health plan?

A–1: (a) For purposes of section 4980B, a group health plan is a plan maintained by an employer or employee organization to provide health care to individuals who have an employment-related connection to the employer or employee organization or to their families. Individuals who have an employment-related connection to the employer or employee organization consist of employees, former employees, the employer, and others associated or formerly associated with the employer or employee organization in a business relationship (including members of a union who are not currently employees). Health care is provided under a plan whether provided directly or through insurance, reimbursement, or otherwise, and whether or not provided through an on-site facility (except as set forth in paragraph (d) of this Q&A–1), or through a cafeteria plan (as defined in section 125) or other flexible benefit arrangement. (See paragraphs (b) through (e) in Q&A–8 of this section for rules regarding the application of the COBRA continuation coverage requirements to certain health flexible spending arrangements.) For purposes of this Q&A–1, insurance includes not only group insurance policies but also one or more individual insurance policies in any arrangement that involves

the provision of health care to two or more employees. A plan maintained by an employer or employee organization is any plan of, or contributed to (directly or indirectly) by, an employer or employee organization. Thus, a group health plan is maintained by an employer or employee organization even if the employer or employee organization does not contribute to it if coverage under the plan would not be available at the same cost to an individual but for the individual's employment-related connection to the employer or employee organization. These rules are further explained in paragraphs (b) through (d) of this Q&A–1. An exception for qualified long-term care services is set forth in paragraph (e) of this Q&A–1, and for medical savings accounts in paragraph (f) of this Q&A–1. See Q&A–6 of this section for rules to determine the number of group health plans that an employer or employee organization maintains.

(b) For purposes of §§ 54.4980B–1 through 54.4980B–10, *health care* has the same meaning as *medical care* under section 213(d). Thus, health care generally includes the diagnosis, cure, mitigation, treatment, or prevention of disease, and any other undertaking for the purpose of affecting any structure or function of the body. Health care also includes transportation primarily for and essential to health care as described in the preceding sentence. However, health care does not include anything that is merely beneficial to the general health of an individual, such as a vacation. Thus, if an employer or employee organization maintains a program that furthers general good health, but the program does not relate to the relief or alleviation of health or medical problems and is generally accessible to and used by employees without regard to their physical condition or state of health, that program is not considered a program that provides health care and so is not a group health plan. For example, if an employer maintains a spa, swimming pool, gymnasium, or other exercise/fitness program or facility that is normally accessible to and used by employees for reasons other than relief of health or medical problems, such a facility does not constitute a program that provides health care and thus is not a group health plan. In contrast, if an employer maintains a drug or alcohol treatment program or a health clinic, or any other facility or program that is intended to relieve or alleviate a physical condition or health problem, the facility or program is considered to be the provision of health care and so is considered a group health plan.

(c) Whether a benefit provided to employees constitutes health care is not affected by whether the benefit is excludable from income under section 132 (relating to certain fringe benefits). For example, if a department store provides its employees discounted prices on all merchandise, including health care items such as drugs or eyeglasses, the mere fact that the discounted prices also apply to health care items will not cause the program to be a plan providing health care, so long as the discount program would normally be accessible to and used by employees without regard to health needs or physical condition. If, however, the employer maintaining the discount program is a health clinic, so that the program is used exclusively by employees with health or medical needs, the program is considered to be a plan providing health care and so is considered to be a group health plan.

(d) The provision of health care at a facility that is located on the premises of an employer or employee organization does not constitute a group health plan if—

(1) The health care consists primarily of first aid that is provided during the employer's working hours for treatment of a health condition, illness, or injury that occurs during those working hours;

(2) The health care is available only to current employees; and

(3) Employees are not charged for the use of the facility.

(e) A plan does not constitute a group health plan subject to COBRA if substantially all of the coverage provided under the plan is for qualified long-term care services (as defined in section 7702B(c)). For this purpose, a plan is permitted to use any reasonable method in determining whether substantially all of the coverage provided

under the plan is for qualified long-term care services.

(f) Under section 106(b)(5), amounts contributed by an employer to a medical savings account (as defined in section 220(d)) are not considered part of a group health plan subject to COBRA. Thus, a plan is not required to make COBRA continuation coverage available with respect to amounts contributed by an employer to a medical savings account. A high deductible health plan does not fail to be a group health plan subject to COBRA merely because it covers a medical savings account holder.

Q–2: For purposes of section 4980B, what is the employer?

A–2: (a) For purposes of section 4980B, employer refers to—

(1) A person for whom services are performed;

(2) Any other person that is a member of a group described in section 414(b), (c), (m), or (o) that includes a person described in paragraph (a)(1) of this Q&A–2; and

(3) Any successor of a person described in paragraph (a)(1) or (2) of this Q&A–2.

(b) An employer is a successor employer if it results from a consolidation, merger, or similar restructuring of the employer or if it is a mere continuation of the employer. See paragraph (c) in Q&A–8 of § 54.4980B–9 for rules describing the circumstances in which a purchaser of substantial assets is a successor employer to the employer selling the assets.

Q–3: What is a multiemployer plan?

A–3: For purposes of §§ 54.4980B–1 through 54.4980B–10, a multiemployer plan is a plan to which more than one employer is required to contribute, that is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and that satisfies such other requirements as the Secretary of Labor may prescribe by regulation. Whenever reference is made in §§ 54.4980B–1 through 54.4980B–10 to a plan of or maintained by an employer or employee organization, the reference includes a multiemployer plan.

Q–4: What group health plans are subject to COBRA?

A–4: (a) All group health plans are subject to COBRA except group health plans described in paragraph (b) of this Q&A–4. Group health plans described in paragraph (b) of this Q&A–4 are referred to in §§ 54.4980B–1 through 54.4980B–10 as excepted from COBRA.

(b) The following group health plans are excepted from COBRA—

(1) Small-employer plans (see Q&A–5 of this section);

(2) Church plans (within the meaning of section 414(e)); and

(3) Governmental plans (within the meaning of section 414(d)).

(c) The COBRA continuation coverage requirements generally do not apply to group health plans that are excepted from COBRA. However, a small-employer plan otherwise excepted from COBRA is nonetheless subject to COBRA with respect to qualified beneficiaries who experience a qualifying event during a period when the plan is not a small-employer plan (see paragraph (g) of Q&A–5 of this section).

(d) Although governmental plans are not subject to the COBRA continuation coverage requirements, group health plans maintained by state or local governments are generally subject to parallel continuation coverage requirements that were added by section 10003 of COBRA to the Public Health Service Act (42 U.S.C. 300bb–1 through 300bb–8), which is administered by the U.S. Department of Health and Human Services. Federal employees and their family members covered under the Federal Employees Health Benefit Program are covered by generally similar, but not parallel, temporary continuation of coverage provisions enacted by the Federal Employees Health Benefits Amendments Act of 1988. See 5 U.S.C. 8905a.

Q–5: What is a small-employer plan?

A–5: (a) Except in the case of a multiemployer plan, a *small-employer plan* is a group health plan maintained by an employer (within the meaning of Q&A–2 of this section) that normally employed fewer than 20 employees (within the meaning of paragraph (c) of this Q&A–5) during the preceding calendar year. In the case of a multiemployer plan, a *small-employer plan* is a group health plan under which each of the

employers contributing to the plan for a calendar year normally employed fewer than 20 employees during the preceding calendar year. See Q&A–6 of this section for rules to determine the number of plans that an employer or employee organization maintains. The rules of this paragraph (a) are illustrated in the following example:

Example. (i) Corporation *S* employs 12 employees, all of whom work and reside in the United States. *S* maintains a group health plan for its employees and their families. *S* is a wholly-owned subsidiary of *P*. In the previous calendar year, the controlled group of corporations including *P* and *S* employed more than 19 employees, although the only employees in the United States of the controlled group that includes *P* and *S* are the 12 employees of *S*.

(ii) Under § 1.414(b)-1 of this chapter, foreign corporations are not excluded from membership in a controlled group of corporations. Consequently, the group health plan maintained by *S* is not a small-employer plan during the current calendar year because the controlled group including *S* normally employed at least 20 employees in the preceding calendar year.

(b) An employer is considered to have normally employed fewer than 20 employees during a particular calendar year if, and only if, it had fewer than 20 employees on at least 50 percent of its typical business days during that year.

(c) All full-time and part-time common law employees of an employer are taken into account in determining whether an employer had fewer than 20 employees; however, an individual who is not a common law employee of the employer is not taken into account. Thus, the following individuals are not counted as employees for purposes of this Q&A–5 even though they are referred to as employees for all other purposes of §§ 54.4980B–1 through 54.4980B–10—

(1) Self-employed individuals (within the meaning of section 401(c)(1));

(2) Independent contractors (and their employees and independent contractors); and

(3) Directors (in the case of a corporation).

(d) In determining the number of the employees of an employer, each full-time employee is counted as one employee and each part-time employee is counted as a fraction of an employee, determined in accordance with paragraph (e) of this Q&A–5.

(e) An employer may determine the number of its employees on a daily basis or a pay period basis. The basis used by the employer must be used with respect to all employees of the employer and must be used for the entire year for which the number of employees is being determined. If an employer determines the number of its employees on a daily basis, it must determine the actual number of full-time employees on each typical business day and the actual number of part-time employees and the hours worked by each of those part-time employees on each typical business day. Each full-time employee counts as one employee on each typical business day and each part-time employee counts as a fraction, with the numerator of the fraction equal to the number of hours worked by that employee and the denominator equal to the number of hours that must be worked on a typical business day in order to be considered a full-time employee. If an employer determines the number of its employees on a pay period basis, it must determine the actual number of full-time employees employed during that pay period and the actual number of part-time employees employed and the hours worked by each of those part-time employees during the pay period. For each day of that pay period, each full-time employee counts as one employee and each part-time employee counts as a fraction, with the numerator of the fraction equal to the number of hours worked by that employee during that pay period and the denominator equal to the number of hours that must be worked during that pay period in order to be considered a full-time employee. The determination of the number of hours required to be considered a full-time employee is based upon the employer's employment practices, except that in no event may the hours required to be considered a full-time employee exceed eight hours for any day or 40 hours for any week.

(f) In the case of a multiemployer plan, the determination of whether the plan is a small-employer plan on any particular date depends on which employers are contributing to the plan on

that date and on the workforce of those employers during the preceding calendar year. If a plan that is otherwise subject to COBRA ceases to be a small-employer plan because of the addition during a calendar year of an employer that did not normally employ fewer than 20 employees on a typical business day during the preceding calendar year, the plan ceases to be excepted from COBRA immediately upon the addition of the new employer. In contrast, if the plan ceases to be a small-employer plan by reason of an increase during a calendar year in the workforce of an employer contributing to the plan, the plan ceases to be excepted from COBRA on the January 1 immediately following the calendar year in which the employer's workforce increased.

(g) A small-employer plan is generally excepted from COBRA. If, however, a plan that has been subject to COBRA (that is, was not a small-employer plan) becomes a small-employer plan, the plan remains subject to COBRA for qualifying events that occurred during the period when the plan was subject to COBRA. The rules of this paragraph (g) are illustrated by the following examples:

Example 1. An employer maintains a group health plan. The employer employed 20 employees on more than 50 percent of its working days during 2001, and consequently the plan is not excepted from COBRA during 2002. Employee *E* resigns and does not work for the employer after January 31, 2002. Under the terms of the plan, *E* is no longer eligible for coverage upon the effective date of the resignation, that is, February 1, 2002. The employer does not hire a replacement for *E*. *E* timely elects and pays for COBRA continuation coverage. The employer employs 19 employees for the remainder of 2002, and consequently the plan is not subject to COBRA in 2003. The plan must nevertheless continue to make COBRA continuation coverage available to *E* during 2003 until the obligation to make COBRA continuation coverage available ceases under the rules of § 54.4980B–7. The obligation could continue until August 1, 2003, the date that is 18 months after the date of *E*'s qualifying event, or longer if *E* is eligible for a disability extension.

Example 2. The facts are the same as in *Example 1*. The employer continues to employ 19 employees throughout 2003 and 2004 and consequently the plan continues to be excepted from COBRA during 2004 and 2005. Spouse *S* is covered under the plan because *S* is married to one of the employer's employees. On April 1, 2002, *S* is divorced from that employee and ceases to be eligible for coverage under the plan. The plan is subject to COBRA during 2002 because *X* normally employed 20 employees during 2001. *S* timely notifies the plan administrator of the divorce and timely elects and pays for COBRA continuation coverage. Even though the plan is generally excepted from COBRA during 2003, 2004, and 2005, it must nevertheless continue to make COBRA continuation coverage available to *S* during those years until the obligation to make COBRA continuation coverage available ceases under the rules of § 54.4980B–7. The obligation could continue until April 1, 2005, the date that is 36 months after the date of *S*'s qualifying event.

Example 3. The facts are the same as in *Example 2*. *C* is a dependent child of one of the employer's employees and is covered under the plan. A dependent child is no longer eligible for coverage under the plan upon the attainment of age 23. *C* attains age 23 on November 16, 2005. The plan is excepted from COBRA with respect to *C* during 2005 because the employer normally employed fewer than 20 employees during 2004. Consequently, the plan is not obligated to make COBRA continuation coverage available to *C* (and would not be obligated to make COBRA continuation coverage available to *C* even if the plan later became subject to COBRA again).

Q–6: How is the number of group health plans that an employer or employee organization maintains determined?

A–6: (a) The rules of this Q&A–6 apply in determining the number of group health plans that an employer or employee organization maintains. All references elsewhere in §§ 54.4980B–1 through 54.4980B–10 to a group health plan are references to a group health plan as determined under Q&A–1 of this section and this Q&A–6. Except as provided in paragraph (b) or (c) of this Q&A–6, all health care benefits, other than benefits for qualified long-term care services (as defined in section 7702B(c)), provided by a corporation, partnership, or other entity or trade or business, or by an employee organization, constitute one group health plan, unless—

(1) It is clear from the instruments governing an arrangement or arrangements to provide health care benefits that the benefits are being provided under separate plans; and

(2) The arrangement or arrangements are operated pursuant to such instruments as separate plans.

(b) A multiemployer plan and a nonmultiemployer plan are always separate plans.

(c) If a principal purpose of establishing separate plans is to evade any requirement of law, then the separate plans will be considered a single plan to the extent necessary to prevent the evasion.

(d) The significance of treating an arrangement as two or more separate group health plans is illustrated by the following examples:

Example 1. (i) Employer X maintains a single group health plan, which provides major medical and prescription drug benefits. Employer Y maintains two group health plans; one provides major medical benefits and the other provides prescription drug benefits.

(ii) *X*'s plan could comply with the COBRA continuation coverage requirements by giving a qualified beneficiary experiencing a qualifying event with respect to X's plan the choice of either electing both major medical and prescription drug benefits or not receiving any COBRA continuation coverage under X's plan. By contrast, for Y's plans to comply with the COBRA continuation coverage requirements, a qualified beneficiary experiencing a qualifying event with respect to each of Y's plans must be given the choice of electing COBRA continuation coverage under either the major medical plan or the prescription drug plan or both.

Example 2. If a joint board of trustees administers one multiemployer plan, that plan will fail to qualify for the small-employer plan exception if any one of the employers whose employees are covered under the plan normally employed 20 or more employees during the preceding calendar year. However, if the joint board of trustees maintains two or more multiemployer plans, then the exception would be available with respect to each of those plans in which each of the employers whose employees are covered under the plan normally employed fewer than 20 employees during the preceding calendar year.

Q–7: What is the plan year?

A–7: (a) The *plan year* is the year that is designated as the plan year in the plan documents.

(b) If the plan documents do not designate a plan year (or if there are no plan documents), then the plan year is determined in accordance with this paragraph (b).

(1) The plan year is the deductible/limit year used under the plan.

(2) If the plan does not impose deductibles or limits on an annual basis, then the plan year is the policy year.

(3) If the plan does not impose deductibles or limits on an annual basis, and either the plan is not insured or the insurance policy is not renewed on an annual basis, then the plan year is the employer's taxable year.

(4) In any other case, the plan year is the calendar year.

Q–8: How do the COBRA continuation coverage requirements apply to cafeteria plans and other flexible benefit arrangements?

A–8: (a)(1) The provision of health care benefits does not fail to be a group health plan merely because those benefits are offered under a cafeteria plan (as defined in section 125) or under any other arrangement under which an employee is offered a choice between health care benefits and other taxable or nontaxable benefits. However, the COBRA continuation coverage requirements apply only to the type and level of coverage under the cafeteria plan or other flexible benefit arrangement that a qualified beneficiary is actually receiving on the day before the qualifying event. See paragraphs (b) through (e) of this Q&A–8 for rules limiting the obligations of certain health flexible spending arrangements.

(2) The rules of this paragraph (a) are illustrated by the following example:

Example: (i) Under the terms of a cafeteria plan, employees can choose among life insurance coverage, membership in a health maintenance organization (HMO), coverage for medical expenses under an indemnity arrangement, and cash compensation. Of these available choices, the HMO and the indemnity arrangement are the arrangements providing health care. The instruments governing the HMO and indemnity arrangements indicate that they are separate group health plans. These group health plans are subject to COBRA. The employer does not provide any group health plan outside of the cafeteria plan. *B* and *C* are unmarried employees. *B* has chosen the life insurance coverage, and *C* has chosen the indemnity arrangement.

(ii) *B* does not have to be offered COBRA continuation coverage upon terminating employment, nor is a subsequent open enrollment period for active employees required to

be made available to *B*. However, if *C* terminates employment and the termination constitutes a qualifying event, *C* must be offered an opportunity to elect COBRA continuation coverage under the indemnity arrangement. If *C* makes such an election and an open enrollment period for active employees occurs while *C* is still receiving the COBRA continuation coverage, *C* must be offered the opportunity to switch from the indemnity arrangement to the HMO (but not to the life insurance coverage because that does not constitute coverage provided under a group health plan).

(b) If a health flexible spending arrangement (health FSA), within the meaning of section 106(c)(2), satisfies the two conditions in paragraph (c) of this Q&A–8 for a plan year, the obligation of the health FSA to make COBRA continuation coverage available to a qualified beneficiary who experiences a qualifying event in that plan year is limited in accordance with paragraphs (d) and (e) of this Q&A–8, as illustrated by an example in paragraph (f) of this Q&A–8. To the extent that a health FSA is obligated to make COBRA continuation coverage available to a qualified beneficiary, the health FSA must comply with all the applicable rules of §§ 54.4980B–1 through 54.4980B–10, including the rules of Q&A–3 in § 54.4980B–5 (relating to limits).

(c) The conditions of this paragraph (c) are satisfied if—

(1) Benefits provided under the health FSA are excepted benefits within the meaning of sections 9831 and 9832; and

(2) The maximum amount that the health FSA can require to be paid for a year of COBRA continuation coverage under Q&A–1 of § 54.4980B–8 equals or exceeds the maximum benefit available under the health FSA for the year.

(d) If the conditions in paragraph (c) of this Q&A–8 are satisfied for a plan year, then the health FSA is not obligated to make COBRA continuation coverage available for any subsequent plan year to any qualified beneficiary who experiences a qualifying event during that plan year.

(e) If the conditions in paragraph (c) of this Q&A–8 are satisfied for a plan year, the health FSA is not obligated to make COBRA continuation coverage available for that plan year to any qualified beneficiary who experiences a qualifying event during that plan year unless, as of the date of the qualifying event, the qualified beneficiary can become entitled to receive during the remainder of the plan year a benefit that exceeds the maximum amount that the health FSA is permitted to require to be paid for COBRA continuation coverage for the remainder of the plan year. In determining the amount of the benefit that a qualified beneficiary can become entitled to receive during the remainder of the plan year, the health FSA may deduct from the maximum benefit available to that qualified beneficiary for the year (based on the election made under the health FSA for that qualified beneficiary before the date of the qualifying event) any reimbursable claims submitted to the health FSA for that plan year before the date of the qualifying event.

(f) The rules of paragraphs (b), (c), (d), and (e) of this Q&A–8 are illustrated by the following example:

Example. (i) An employer maintains a group health plan providing major medical benefits and a group health plan that is a health FSA, and the plan year for each plan is the calendar year. Both the plan providing major medical benefits and the health FSA are subject to COBRA. Under the health FSA, during an open season before the beginning of each calendar year, employees can elect to reduce their compensation during the upcoming year by up to $1200 per year and have that same amount contributed to a health flexible spending account. The employer contributes an additional amount to the account equal to the employee's salary reduction election for the year. Thus, the maximum amount available to an employee under the health FSA for a year is two times the amount of the employee's salary reduction election for the year. This amount may be paid to the employee during the year as reimbursement for health expenses not covered by the employer's major medical plan (such as deductibles, copayments, prescription drugs, or eyeglasses). The employer determined, in accordance with section 4980B(f)(4), that a reasonable estimate of the cost of providing coverage for similarly situated nonCOBRA beneficiaries for 2002 under this health FSA is equal to two times their salary reduction election for 2002 and, thus, that two times the salary reduction election is the applicable premium for 2002.

(ii) Because the employer provides major medical benefits under another group health plan, and because the maximum benefit that any employee can receive under the health FSA is not greater than two times the employee's salary reduction election for the

plan year, benefits under this health FSA are excepted benefits within the meaning of sections 9831 and 9832. Thus, the first condition of paragraph (c) of this Q&A–8 is satisfied for the year. The maximum amount that a plan can require to be paid for coverage (outside of coverage required to be made available due to a disability extension) under Q&A–1 of § 54.4980B–8 is 102 percent of the applicable premium. Thus, the maximum amount that the health FSA can require to be paid for coverage for the 2002 plan year is 2.04 times the employee's salary reduction election for the plan year. Because the maximum benefit available under the health FSA is 2.0 times the employee's salary reduction election for the year, the maximum benefit available under the health FSA for the year is less than the maximum amount that the health FSA can require to be paid for coverage for the year. Thus, the second condition in paragraph (c) of this Q&A–8 is also satisfied for the 2002 plan year. Because both conditions in paragraph (c) of this Q&A–8 are satisfied for 2002, with respect to any qualifying event occurring in 2002, the health FSA is not obligated to make COBRA continuation coverage available for any year after 2002.

(iii) Whether the health FSA is obligated to make COBRA continuation coverage available in 2002 to a qualified beneficiary with respect to a qualifying event that occurs in 2002 depends upon the maximum benefit that would be available to the qualified beneficiary under COBRA continuation coverage for that plan year. *Case 1:* Employee *B* has elected to reduce *B*'s salary by $1200 for 2002. Thus, the maximum benefit that *B* can become entitled to receive under the health FSA during the entire year is $2400. *B* experiences a qualifying event that is the termination of *B*'s employment on May 31, 2002. As of that date, *B* had submitted $300 of reimbursable expenses under the health FSA. Thus, the maximum benefit that *B* could become entitled to receive for the remainder of 2002 is $2100. The maximum amount that the health FSA can require to be paid for COBRA continuation coverage for the remainder of 2002 is 102 percent times 1/12 of the applicable premium for 2002 times the number of months remaining in 2002 after the date of the qualifying event. In *B*'s case, the maximum amount that the health FSA can require to be paid for COBRA continuation coverage for 2002 is 2.04 times $1200, or $2448. One-twelfth of $2448 is $204. Because seven months remain in the plan year, the maximum amount that the health FSA can require to be paid for *B*'s coverage for the remainder of the year is seven times $204, or $1428. Because $1428 is less than the maximum benefit that *B* could become entitled to receive for the remainder of the year ($2100), the health FSA is required to make COBRA continuation coverage available to *B* for the remainder of 2002 (but not for any subsequent year).

(iv) *Case 2:* The facts are the same as in *Case 1* except that *B* had submitted $1000 of reimbursable expenses as of the date of the qualifying event. In that case, the maximum benefit available to *B* for the remainder of the year would be $1400 instead of $2100. Because the maximum amount that the health FSA can require to be paid for *B*'s coverage is $1428, and because the $1400 maximum benefit for the remainder of the year does not exceed $1428, the health FSA is not obligated to make COBRA continuation coverage available to *B* in 2002 (or any later year). (Of course, the administrator of the health FSA is permitted to make COBRA continuation coverage available to every qualified beneficiary in the year that the qualified beneficiary's qualifying event occurs in order to avoid having to determine the maximum benefit available for each qualified beneficiary for the remainder of the plan year.)

Q–9: What is the effect of a group health plan's failure to comply with the requirements of section 4980B(f)?

A–9: Under section 4980B(a), if a group health plan subject to COBRA fails to comply with section 4980B(f), an excise tax is imposed. Moreover, non-tax remedies may be available if the plan fails to comply with the parallel requirements in ERISA, which are administered by the Department of Labor.

Q–10: Who is liable for the excise tax if a group health plan fails to comply with the requirements of section 4980B(f)?

A–10: (a) In general, the excise tax is imposed on the employer maintaining the plan, except that in the case of a multiemployer plan (see Q&A–3 of this section for a definition of multiemployer plan) the excise tax is imposed on the plan.

(b) In certain circumstances, the excise tax is also imposed on a person involved with the provision of benefits under the plan (other than in the capacity of an employee), such as an insurer providing benefits under the plan or a third party administrator administering claims under the plan. In general, such a person will be liable for the excise tax if the person assumes, under a legally enforceable written agreement, the responsibility for performing the act to which the failure to comply with the COBRA continuation coverage requirements relates. Such a person

will be liable for the excise tax notwithstanding the absence of a written agreement assuming responsibility for complying with COBRA if the person provides coverage under the plan to a similarly situated nonCOBRA beneficiary (see Q&A–3 of § 54.4980B–3 for a definition of similarly situated nonCOBRA beneficiaries) and the employer or plan administrator submits a written request to the person to provide to a qualified beneficiary the same coverage that the person provides to the similarly situated nonCOBRA beneficiary. If the person providing coverage under the plan to a similarly situated nonCOBRA beneficiary is the plan administrator and the qualifying event is a divorce or legal separation or a dependent child's ceasing to be covered under the generally applicable requirements of the plan, the plan administrator will also be liable for the excise tax if the qualified beneficiary submits a written request for coverage.

Q–11: If a person is liable for the excise tax under section 4980B, what form must the person file and what is the due date for the filing and payment of the excise tax?

A–11: (a) *In general. See* §§ 54.6011–2 and 54.6151–1.

(b) *Due date for filing of return by employers or other persons responsible for benefits under a group health plan. See* § 54.6071–1(a)(1).

(c) *Due date for filing of return by multiemployer plans. See* § 54.6071–1(a)(2).

(d) *Effective/applicability date.* In the case of an employer or other person mentioned in paragraph (b) of this Q & A–11, the rules in this Q & A–11 are effective for taxable years beginning on or after January 1, 2010. In the case of a plan mentioned in paragraph (c) of this Q & A–11, the rules in this Q & A–11 are effective for plan years beginning on or after January 1, 2010.

[T.D. 8812, 64 FR 5174, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1849, Jan. 10, 2001; T.D. 9457, 74 FR 45997, Sept. 8, 2009]

§ 54.4980B–3 Qualified beneficiaries.

The determination of who is a qualified beneficiary, an employee, or a covered employee, and of who are the similarly situated nonCOBRA beneficiaries is addressed in the following questions-and-answers:

Q–1: Who is a qualified beneficiary?

A–1: (a)(1) Except as set forth in paragraphs (c) through (f) of this Q&A–1, a qualified beneficiary is—

(i) Any individual who, on the day before a qualifying event, is covered under a group health plan by virtue of being on that day either a covered employee, the spouse of a covered employee, or a dependent child of the covered employee; or

(ii) Any child who is born to or placed for adoption with a covered employee during a period of COBRA continuation coverage.

(2) In the case of a qualifying event that is the bankruptcy of the employer, a covered employee who had retired on or before the date of substantial elimination of group health plan coverage is also a qualified beneficiary, as is any spouse, surviving spouse, or dependent child of such a covered employee if, on the day before the bankruptcy qualifying event, the spouse, surviving spouse, or dependent child is a beneficiary under the plan.

(3) In general, an individual (other than a child who is born to or placed for adoption with a covered employee during a period of COBRA continuation coverage) who is not covered under a plan on the day before the qualifying event cannot be a qualified beneficiary with respect to that qualifying event, and the reason for the individual's lack of actual coverage (such as the individual's having declined participation in the plan or failed to satisfy the plan's conditions for participation) is not relevant for this purpose. However, if the individual is denied or not offered coverage under a plan under circumstances in which the denial or failure to offer constitutes a violation of applicable law (such as the Americans with Disabilities Act, 42 U.S.C. 12101–12213, the special enrollment rules of section 9801, or the requirements of section 9802 prohibiting discrimination in eligibility to enroll in a group health plan based on health status), then, for purposes of §§ 54.4980B–1 through 54.4980B–10, the individual will be considered to have had the coverage that was wrongfully denied or not offered.

(4) Paragraph (b) of this Q&A–1 describes how certain family members

are not qualified beneficiaries even if they become covered under the plan; paragraphs (c), (d), and (e) of this Q&A–1 place limits on the general rules of this paragraph (a) concerning who is a qualified beneficiary; paragraph (f) of this Q&A–1 provides when an individual who has been a qualified beneficiary ceases to be a qualified beneficiary; paragraph (g) of this Q&A–1 defines *placed for adoption*; and paragraph (h) of this Q&A–1 contains examples.

(b) In contrast to a child who is born to or placed for adoption with a covered employee during a period of COBRA continuation coverage, an individual who marries any qualified beneficiary on or after the date of the qualifying event and a newborn or adopted child (other than one born to or placed for adoption with a covered employee) are not qualified beneficiaries by virtue of the marriage, birth, or placement for adoption or by virtue of the individual's status as the spouse or the child's status as a dependent of the qualified beneficiary. These new family members do not themselves become qualified beneficiaries even if they become covered under the plan. (For situations in which a plan is required to make coverage available to new family members of a qualified beneficiary who is receiving COBRA continuation coverage, see Q&A–5 of § 54.4980B–5, paragraph (c) in Q&A–4 of § 54.4980B–5, and section 9801(f)(2).)

(c) An individual is not a qualified beneficiary if, on the day before the qualifying event referred to in paragraph (a) of this Q&A–1, the individual is covered under the group health plan by reason of another individual's election of COBRA continuation coverage and is not already a qualified beneficiary by reason of a prior qualifying event.

(d) A covered employee can be a qualified beneficiary only in connection with a qualifying event that is the termination, or reduction of hours, of the covered employee's employment, or that is the bankruptcy of the employer.

(e) An individual is not a qualified beneficiary if the individual's status as a covered employee is attributable to a period in which the individual was a nonresident alien who received from the individual's employer no earned income (within the meaning of section 911(d)(2)) that constituted income from sources within the United States (within the meaning of section 861(a)(3)). If, pursuant to the preceding sentence, an individual is not a qualified beneficiary, then a spouse or dependent child of the individual is not considered a qualified beneficiary by virtue of the relationship to the individual.

(f) A qualified beneficiary who does not elect COBRA continuation coverage in connection with a qualifying event ceases to be a qualified beneficiary at the end of the election period (see Q&A–1 of § 54.4980B–6). Thus, for example, if such a former qualified beneficiary is later added to a covered employee's coverage (e.g., during an open enrollment period) and then another qualifying event occurs with respect to the covered employee, the former qualified beneficiary does not become a qualified beneficiary by reason of the second qualifying event. If a covered employee who is a qualified beneficiary does not elect COBRA continuation coverage during the election period, then any child born to or placed for adoption with the covered employee on or after the date of the qualifying event is not a qualified beneficiary. Once a plan's obligation to make COBRA continuation coverage available to an individual who has been a qualified beneficiary ceases under the rules of § 54.4980B–7, the individual ceases to be a qualified beneficiary.

(g) For purposes of §§ 54.4980B–1 through 54.4980B–10, *placement for adoption* or *being placed for adoption* means the assumption and retention by the covered employee of a legal obligation for total or partial support of a child in anticipation of the adoption of the child. The child's placement for adoption with the covered employee terminates upon the termination of the legal obligation for total or partial support. A child who is immediately adopted by the covered employee without a preceding placement for adoption is considered to be placed for adoption on the date of the adoption.

(h) The rules of this Q&A–1 are illustrated by the following examples:

Example 1. (i) *B* is a single employee who voluntarily terminates employment and

elects COBRA continuation coverage under a group health plan. To comply with the requirements of section 9801(f), the plan permits a covered employee who marries to have her or his spouse covered under the plan. One month after electing COBRA continuation coverage, *B* marries and chooses to have *B*'s spouse covered under the plan.

(ii) *B*'s spouse is not a qualified beneficiary. Thus, if *B* dies during the period of COBRA continuation coverage, the plan does not have to offer *B*'s surviving spouse an opportunity to elect COBRA continuation coverage.

Example 2. (i) *C* is a married employee who terminates employment. *C* elects COBRA continuation coverage for *C* but not *C*'s spouse, and *C*'s spouse declines to elect such coverage. *C*'s spouse thus ceases to be a qualified beneficiary. At the next open enrollment period, *C* adds the spouse as a beneficiary under the plan.

(ii) The addition of the spouse during the open enrollment period does not make the spouse a qualified beneficiary. The plan thus will not have to offer the spouse an opportunity to elect COBRA continuation coverage upon a later divorce from or death of *C*.

Example 3. (i) Under the terms of a group health plan, a covered employee's child, upon attaining age 19, ceases to be a dependent eligible for coverage.

(ii) At that time, the child must be offered an opportunity to elect COBRA continuation coverage. If the child elects COBRA continuation coverage, the child marries during the period of the COBRA continuation coverage, and the child's spouse becomes covered under the group health plan, the child's spouse is not a qualified beneficiary.

Example 4. (i) *D* is a single employee who, upon retirement, is given the opportunity to elect COBRA continuation coverage but declines it in favor of an alternative offer of 12 months of employer-paid retiree health benefits. At the end of the election period, *D* ceases to be a qualified beneficiary and will not have to be given another opportunity to elect COBRA continuation coverage (at the end of those 12 months or at any other time). *D* marries *E* during the period of retiree health coverage and, under the terms of that coverage, *E* becomes covered under the plan.

(ii) If a divorce from or death of *D* will result in *E*'s losing coverage, *E* will be a qualified beneficiary because *E*'s coverage under the plan on the day before the qualifying event (that is, the divorce or death) will have been by reason of *D*'s acceptance of 12 months of employer-paid coverage after the prior qualifying event (*D*'s retirement) rather than by reason of an election of COBRA continuation coverage.

Example 5. (i) The facts are the same as in *Example 4,* except that, under the terms of the plan, the divorce or death does not cause *E* to lose coverage so that *E* continues to be covered for the balance of the original 12-month period.

(ii) *E* does not have to be allowed to elect COBRA continuation coverage because the loss of coverage at the end of the 12-month period is not caused by the divorce or death, and thus the divorce or death does not constitute a qualifying event. See Q&A–1 of § 54.4980B–4.

Q–2: Who is an employee and who is a covered employee?

A–2: (a)(1) For purposes of §§ 54.4980B–1 through 54.4980B–10 (except for purposes of Q&A–5 in § 54.4980B–2, relating to the exception from COBRA for plans maintained by an employer with fewer than 20 employees), an *employee* is any individual who is eligible to be covered under a group health plan by virtue of the performance of services for the employer maintaining the plan or by virtue of membership in the employee organization maintaining the plan. Thus, for purposes of §§ 54.4980B–1 through 54.4980B–10 (except for purposes of Q&A–5 in § 54.4980B–2), the following individuals are employees if their relationship to the employer maintaining the plan makes them eligible to be covered under the plan—

(i) Self-employed individuals (within the meaning of section 401(c)(1));

(ii) Independent contractors (and their employees and independent contractors); and

(iii) Directors (in the case of a corporation).

(2) Similarly, whenever reference is made in §§ 54.4980B–1 through 54.4980B–10 (except in Q&A–5 of § 54.4980B–2) to an employment relationship (such as by referring to the termination of employment of an employee or to an employee's being employed by an employer), the reference includes the relationship of those individuals who are employees within the meaning of this paragraph (a). See paragraph (c) in Q&A–5 of § 54.4980B–2 for a narrower meaning of employee solely for purposes of Q&A–5 of § 54.4980B–2.

(b) For purposes of §§ 54.4980B–1 through 54.4980B–10, a *covered employee* is any individual who is (or was) provided coverage under a group health plan (other than a plan that is excepted from COBRA on the date of the qualifying event; see Q&A–4 of § 54.4980B–2) by virtue of being or having been an

employee. For example, a retiree or former employee who is covered by a group health plan is a covered employee if the coverage results in whole or in part from her or his previous employment. An employee (or former employee) who is merely eligible for coverage under a group health plan is generally not a covered employee if the employee (or former employee) is not actually covered under the plan. In general, the reason for the employee's (or former employee's) lack of actual coverage (such as having declined participation in the plan or having failed to satisfy the plan's conditions for participation) is not relevant for this purpose. However, if the employee (or former employee) is denied or not offered coverage under circumstances in which the denial or failure to offer constitutes a violation of applicable law (such as the Americans with Disabilities Act, 42 U.S.C. 12101 through 12213, the special enrollment rules of section 9801, or the requirements of section 9802 prohibiting discrimination in eligibility to enroll in a group health plan based on health status), then, for purposes of §§ 54.4980B–1 through 54.4980B–10, the employee (or former employee) will be considered to have had the coverage that was wrongfully denied or not offered.

Q–3: Who are the similarly situated nonCOBRA beneficiaries?

A–3: For purposes of §§ 54.4980B–1 through 54.4980B–10, *similarly situated nonCOBRA beneficiaries* means the group of covered employees, spouses of covered employees, or dependent children of covered employees receiving coverage under a group health plan maintained by the employer or employee organization who are receiving that coverage for a reason other than the rights provided under the COBRA continuation coverage requirements and who, based on all of the facts and circumstances, are most similarly situated to the situation of the qualified beneficiary immediately before the qualifying event.

[T.D. 8812, 64 FR 5176, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1852, Jan. 10, 2001]

§ 54.4980B–4 Qualifying events.

The determination of what constitutes a qualifying event is addressed in the following questions and answers:

Q–1: What is a qualifying event?

A–1: (a) A *qualifying event* is an event that satisfies paragraphs (b), (c), and (d) of this Q&A–1. Paragraph (e) of this Q&A–1 further explains a reduction of hours of employment, paragraph (f) of this Q&A–1 describes the treatment of children born to or placed for adoption with a covered employee during a period of COBRA continuation coverage, and paragraph (g) of this Q&A–1 contains examples. See Q&A–1 through Q&A–3 of § 54.4980B–10 for special rules in the case of leave taken under the Family and Medical Leave Act of 1993 (29 U.S.C. 2601–2619).

(b) An event satisfies this paragraph (b) if the event is any of the following—

(1) The death of a covered employee;

(2) The termination (other than by reason of the employee's gross misconduct), or reduction of hours, of a covered employee's employment;

(3) The divorce or legal separation of a covered employee from the employee's spouse;

(4) A covered employee's becoming entitled to Medicare benefits under Title XVIII of the Social Security Act (42 U.S.C. 1395–1395ggg);

(5) A dependent child's ceasing to be a dependent child of a covered employee under the generally applicable requirements of the plan; or

(6) A proceeding in bankruptcy under Title 11 of the United States Code with respect to an employer from whose employment a covered employee retired at any time.

(c) An event satisfies this paragraph (c) if, under the terms of the group health plan, the event causes the covered employee, or the spouse or a dependent child of the covered employee, to lose coverage under the plan. For this purpose, to lose coverage means to cease to be covered under the same terms and conditions as in effect immediately before the qualifying event. Any increase in the premium or contribution that must be paid by a covered employee (or the spouse or dependent child of a covered employee) for coverage under a group health plan that results from the occurrence of one

of the events listed in paragraph (b) of this Q&A–1 is a loss of coverage. In the case of an event that is the bankruptcy of the employer, lose coverage also means any substantial elimination of coverage under the plan, occurring within 12 months before or after the date the bankruptcy proceeding commences, for a covered employee who had retired on or before the date of the substantial elimination of group health plan coverage or for any spouse, surviving spouse, or dependent child of such a covered employee if, on the day before the bankruptcy qualifying event, the spouse, surviving spouse, or dependent child is a beneficiary under the plan. For purposes of this paragraph (c), a loss of coverage need not occur immediately after the event, so long as the loss of coverage occurs before the end of the maximum coverage period (see Q&A–4 and Q&A–6 of § 54.4980B–7). However, if neither the covered employee nor the spouse or a dependent child of the covered employee loses coverage before the end of what would be the maximum coverage period, the event does not satisfy this paragraph (c). If coverage is reduced or eliminated in anticipation of an event (for example, an employer's eliminating an employee's coverage in anticipation of the termination of the employee's employment, or an employee's eliminating the coverage of the employee's spouse in anticipation of a divorce or legal separation), the reduction or elimination is disregarded in determining whether the event causes a loss of coverage.

(d) An event satisfies this paragraph (d) if it occurs while the plan is subject to COBRA. Thus, an event will not satisfy this paragraph (d) if it occurs while the plan is excepted from COBRA (see Q&A–4 of § 54.4980B–2). Even if the plan later becomes subject to COBRA, it is not required to make COBRA continuation coverage available to anyone whose coverage ends as a result of an event during a year in which the plan is excepted from COBRA. For example, if a group health plan is excepted from COBRA as a small-employer plan during the year 2001 (see Q&A–5 of § 54.4980B–2) and an employee terminates employment on December 31, 2001, the termination is not a qualifying event and the plan is not required to permit the employee to elect COBRA continuation coverage. This is the case even if the plan ceases to be a small-employer plan as of January 1, 2002. Also, the same result will follow even if the employee is given three months of coverage beyond December 31 (that is, through March of 2002), because there will be no qualifying event as of the termination of coverage in March. However, if the employee's spouse is initially provided with the three-month coverage through March 2002, but the spouse divorces the employee before the end of the three months and loses coverage as a result of the divorce, the divorce will constitute a qualifying event during 2002 and so entitle the spouse to elect COBRA continuation coverage. See Q&A–7 of § 54.4980B–7 regarding the maximum coverage period in such a case.

(e) A reduction of hours of a covered employee's employment occurs whenever there is a decrease in the hours that a covered employee is required to work or actually works, but only if the decrease is not accompanied by an immediate termination of employment. This is true regardless of whether the covered employee continues to perform services following the reduction of hours of employment. For example, an absence from work due to disability, a temporary layoff, or any other reason (other than due to leave that is FMLA leave; see § 54.4980B–10) is a reduction of hours of a covered employee's employment if there is not an immediate termination of employment. If a group health plan measures eligibility for the coverage of employees by the number of hours worked in a given time period, such as the preceding month or quarter, and an employee covered under the plan fails to work the minimum number of hours during that time period, the failure to work the minimum number of required hours is a reduction of hours of that covered employee's employment.

(f) The qualifying event of a qualified beneficiary who is a child born to or placed for adoption with a covered employee during a period of COBRA continuation coverage is the qualifying event giving rise to the period of

COBRA continuation coverage during which the child is born or placed for adoption. If a second qualifying event has occurred before the child is born or placed for adoption (such as the death of the covered employee), then the second qualifying event also applies to the newborn or adopted child. See Q&A–6 of § 54.4980B–7.

(g) The rules of this Q&A–1 are illustrated by the following examples, in each of which the group health plan is subject to COBRA:

Example 1. (i) An employee who is covered by a group health plan terminates employment (other than by reason of the employee's gross misconduct) and, beginning with the day after the last day of employment, is given 3 months of employer-paid coverage under the same terms and conditions as before that date. At the end of the three months, the coverage terminates.

(ii) The loss of coverage at the end of the three months results from the termination of employment and, thus, the termination of employment is a qualifying event.

Example 2. (i) An employee who is covered by a group health plan retires (which is a termination of employment other than by reason of the employee's gross misconduct) and, upon retirement, is required to pay an increased amount for the same group health coverage that the employee had before retirement.

(ii) The increase in the premium or contribution required for coverage is a loss of coverage under paragraph (c) of this Q&A–1 and, thus, the retirement is a qualifying event.

Example 3. (i) An employee and the employee's spouse are covered under an employer's group health plan. The employee retires and is given identical coverage for life. However, the plan provides that the spousal coverage will not be continued beyond six months unless a higher premium for the spouse is paid to the plan.

(ii) The requirement for the spouse to pay a higher premium at the end of the six months is a loss of coverage under paragraph (c) of this Q&A–1. Thus, the retirement is a qualifying event and the spouse must be given an opportunity to elect COBRA continuation coverage.

Example 4. (i) *F* is a covered employee who is married to *G*, and both are covered under a group health plan maintained by *F*'s employer. *F* and *G* are divorced. Under the terms of the plan, the divorce causes *G* to lose coverage. The divorce is a qualifying event, and *G* elects COBRA continuation coverage, remarries during the period of COBRA continuation coverage, and *G*'s new spouse becomes covered under the plan. (See Q&A–5 in § 54.4980B–5, paragraph (c) in Q&A–4 of § 54.4980B–5, and section 9801(f)(2).) *G* dies. Under the terms of the plan, the death causes *G*'s new spouse to lose coverage under the plan.

(ii) *G*'s death is not a qualifying event because *G* is not a covered employee.

Example 5. (i) An employer maintains a group health plan for both active employees and retired employees (and their families). The coverage for active employees and retired employees is identical, and the employer does not require retirees to pay more for coverage than active employees. The plan does not make COBRA continuation coverage available when an employee retires (and is not required to because the retired employee has not lost coverage under the plan). The employer amends the plan to eliminate coverage for retired employees effective January 1, 2002. On that date, several retired employees (and their spouses and dependent children) have been covered under the plan since their retirement for less than the maximum coverage period that would apply to them in connection with their retirement.

(ii) The elimination of retiree coverage under these circumstances is a deferred loss of coverage for those retirees (and their spouses and dependent children) under paragraph (c) of this Q&A–1 and, thus, the retirement is a qualifying event. The plan must make COBRA continuation coverage available to them for the balance of the maximum coverage period that applies to them in connection with the retirement.

Q–2: Are the facts surrounding a termination of employment (such as whether it was voluntary or involuntary) relevant in determining whether the termination of employment is a qualifying event?

A–2: Apart from facts constituting gross misconduct, the facts surrounding the termination or reduction of hours are irrelevant in determining whether a qualifying event has occurred. Thus, it does not matter whether the employee voluntarily terminated or was discharged. For example, a strike or a lockout is a termination or reduction of hours that constitutes a qualifying event if the strike or lockout results in a loss of coverage as described in paragraph (c) of Q&A–1 of this section. Similarly, a layoff that results in such a loss of coverage is a qualifying event.

[T.D. 8812, 64 FR 5178, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1852, Jan. 10, 2001]

§ 54.4980B–5 COBRA continuation coverage.

The following questions-and-answers address the requirements for coverage to constitute COBRA continuation coverage:

Q–1: What is COBRA continuation coverage?

A–1: (a) If a qualifying event occurs, each qualified beneficiary (other than a qualified beneficiary for whom the qualifying event will not result in any immediate or deferred loss of coverage) must be offered an opportunity to elect to receive the group health plan coverage that is provided to similarly situated nonCOBRA beneficiaries (ordinarily, the same coverage that the qualified beneficiary had on the day before the qualifying event). See Q&A–3 of § 54.4980B–3 for the definition of similarly situated nonCOBRA beneficiaries. This coverage is COBRA continuation coverage. If coverage is modified for similarly situated nonCOBRA beneficiaries, then the coverage made available to qualified beneficiaries is modified in the same way. If the continuation coverage offered differs in any way from the coverage made available to similarly situated nonCOBRA beneficiaries, the coverage offered does not constitute COBRA continuation coverage and the group health plan is not in compliance with COBRA unless other coverage that does constitute COBRA continuation coverage is also offered. Any elimination or reduction of coverage in anticipation of an event described in paragraph (b) of Q&A–1 of § 54.4980B–4 is disregarded for purposes of this Q&A–1 and for purposes of any other reference in §§ 54.4980B–1 through 54.4980B–10 to coverage in effect immediately before (or on the day before) a qualifying event. COBRA continuation coverage must not be conditioned upon, or discriminate on the basis of lack of, evidence of insurability.

(b) In the case of a qualified beneficiary who is a child born to or placed for adoption with a covered employee during a period of COBRA continuation coverage, the child is generally entitled to elect immediately to have the same coverage that dependent children of active employees receive under the benefit packages under which the covered employee has coverage at the time of the birth or placement for adoption. Such a child would be entitled to elect coverage different from that elected by the covered employee during the next available open enrollment period under the plan. See Q&A–4 of this section.

Q–2: What deductibles apply if COBRA continuation coverage is elected?

A–2: (a) Qualified beneficiaries electing COBRA continuation coverage generally are subject to the same deductibles as similarly situated nonCOBRA beneficiaries. If a qualified beneficiary's COBRA continuation coverage begins before the end of a period prescribed for accumulating amounts toward deductibles, the qualified beneficiary must retain credit for expenses incurred toward those deductibles before the beginning of COBRA continuation coverage as though the qualifying event had not occurred. The specific application of this rule depends on the type of deductible, as set forth in paragraphs (b) through (d) of this Q&A–2. Special rules are set forth in paragraph (e) of this Q&A–2, and examples appear in paragraph (f) of this Q&A–2.

(b) If a deductible is computed separately for each individual receiving coverage under the plan, each individual's remaining deductible amount (if any) on the date COBRA continuation coverage begins is equal to that individual's remaining deductible amount immediately before that date.

(c) If a deductible is computed on a family basis, the remaining deductible for the family on the date that COBRA continuation coverage begins depends on the members of the family electing COBRA continuation coverage. In computing the family deductible that remains on the date COBRA continuation coverage begins, only the expenses of those family members receiving COBRA continuation coverage need be taken into account. If the qualifying event results in there being more than one family unit (for example, because of a divorce), the family deductible may be computed separately for each resulting family unit based on the members in each unit. These rules apply regardless of whether the plan provides that the family deductible is an alternative to individual

deductibles or an additional requirement.

(d) Deductibles that are not described in paragraph (b) or (c) of this Q&A–2 must be treated in a manner consistent with the principles set forth in those paragraphs.

(e) If a deductible is computed on the basis of a covered employee's compensation instead of being a fixed dollar amount and the employee remains employed during the period of COBRA continuation coverage, the plan is permitted to choose whether to apply the deductible by treating the employee's compensation as continuing without change for the duration of the COBRA continuation coverage at the level that was used to compute the deductible in effect immediately before the COBRA continuation coverage began, or to apply the deductible by taking the employee's actual compensation into account. In applying a deductible that is computed on the basis of the covered employee's compensation instead of being a fixed dollar amount, for periods of COBRA continuation coverage in which the employee is not employed by the employer, the plan is required to compute the deductible by treating the employee's compensation as continuing without change for the duration of the COBRA continuation coverage either at the level that was used to compute the deductible in effect immediately before the COBRA continuation coverage began or at the level that was used to compute the deductible in effect immediately before the employee's employment was terminated.

(f) The rules of this Q&A–2 are illustrated by the following examples; in each example, deductibles under the plan are determined on a calendar year basis:

Example 1. (i) A group health plan applies a separate $100 annual deductible to each individual it covers. The plan provides that the spouse and dependent children of a covered employee will lose coverage on the last day of the month after the month of the covered employee's death. A covered employee dies on June 11, 2001. The spouse and the two dependent children elect COBRA continuation coverage, which will begin on August 1, 2001. As of July 31, 2001, the spouse has incurred $80 of covered expenses, the older child has incurred no covered expenses, and the younger one has incurred $120 of covered expenses (and therefore has already satisfied the deductible).

(ii) At the beginning of COBRA continuation coverage on August 1, the spouse has a remaining deductible of $20, the older child still has the full $100 deductible, and the younger one has no further deductible.

Example 2. (i) A group health plan applies a separate $200 annual deductible to each individual it covers, except that each family member is treated as having satisfied the individual deductible once the family has incurred $500 of covered expenses during the year. The plan provides that upon the divorce of a covered employee, coverage will end immediately for the employee's spouse and any children who do not remain in the employee's custody. A covered employee with four dependent children is divorced, the spouse obtains custody of the two oldest children, and the spouse and those children all elect COBRA continuation coverage to begin immediately. The family had accumulated $420 of covered expenses before the divorce, as follows: $70 by each parent, $200 by the oldest child, $80 by the youngest child, and none by the other two children.

(ii) The resulting family consisting of the spouse and the two oldest children accumulated a total of $270 of covered expenses, and thus the remaining deductible for that family could be as high as $230 (because the plan would not have to count the incurred expenses of the covered employee and the youngest child). The remaining deductible for the resulting family consisting of the covered employee and the two youngest children is not subject to the rules of this Q&A–2 because their coverage is not COBRA continuation coverage.

Example 3. Each year a group health plan pays 70 percent of the cost of an individual's psychotherapy after that individual's first three visits during the year. A qualified beneficiary whose election of COBRA continuation coverage takes effect beginning August 1, 2001 and who has already made two visits as of that date need only pay for one more visit before the plan must begin to pay 70 percent of the cost of the remaining visits during 2001.

Example 4. (i) A group health plan has a $250 annual deductible per covered individual. The plan provides that if the deductible is not satisfied in a particular year, expenses incurred during October through December of that year are credited toward satisfaction of the deductible in the next year. A qualified beneficiary who has incurred covered expenses of $150 from January through September of 2001 and $40 during October elects COBRA continuation coverage beginning November 1, 2001.

(ii) The remaining deductible amount for this qualified beneficiary is $60 at the beginning of the COBRA continuation coverage. If

this individual incurs covered expenses of $50 in November and December of 2001 combined (so that the $250 deductible for 2001 is not satisfied), the $90 incurred from October through December of 2001 are credited toward satisfaction of the deductible amount for 2002.

Q–3: How do a plan's limits apply to COBRA continuation coverage?

A–3: (a) Limits are treated in the same way as deductibles (see Q&A–2 of this section). This rule applies both to limits on plan benefits (such as a maximum number of hospital days or dollar amount of reimbursable expenses) and limits on out-of-pocket expenses (such as a limit on copayments, a limit on deductibles plus copayments, or a catastrophic limit). This rule applies equally to annual and lifetime limits and applies equally to limits on specific benefits and limits on benefits in the aggregate under the plan.

(b) The rule of this Q&A–3 is illustrated by the following examples; in each example limits are determined on a calendar year basis:

Example 1. (i) A group health plan pays for a maximum of 150 days of hospital confinement per individual per year. A covered employee who has had 20 days of hospital confinement as of May 1, 2001 terminates employment and elects COBRA continuation coverage as of that date.

(ii) During the remainder of the year 2001 the plan need only pay for a maximum of 130 days of hospital confinement for this individual.

Example 2. (i) A group health plan reimburses a maximum of $20,000 of covered expenses per family per year, and the same $20,000 limit applies to unmarried covered employees. A covered employee and spouse who have no children divorce on May 1, 2001, and the spouse elects COBRA continuation coverage as of that date. In 2001, the employee had incurred $5,000 of expenses and the spouse had incurred $8,000 before May 1.

(ii) The plan can limit its reimbursement of the amount of expenses incurred by the spouse on and after May 1 for the remainder of the year to $12,000 ($20,000 − $8,000 = $12,000). The remaining limit for the employee is not subject to the rules of this Q&A–3 because the employee's coverage is not COBRA continuation coverage.

Example 3. (i) A group health plan pays for 80 percent of covered expenses after satisfaction of a $100-per-individual deductible, and the plan pays for 100 percent of covered expenses after a family has incurred out-of-pocket costs of $2,000. The plan provides that upon the divorce of a covered employee, coverage will end immediately for the employee's spouse and any children who do not remain in the employee's custody. An employee and spouse with three dependent children divorce on June 1, 2001, and one of the children remains with the employee. The spouse elects COBRA continuation coverage as of that date for the spouse and the other two children. During January through May of 2001, the spouse incurred $600 of covered expenses and each of the two children in the spouse's custody after the divorce incurred covered expenses of $1,100. This resulted in total out-of-pocket costs for these three individuals of $800 ($300 total for the three deductibles, plus $500 for 20 percent of the other $2,500 in incurred expenses [$600 + $1,100 + $1,100 = $2,800; $2,800 − $300 = $2,500]).

(ii) For the remainder of 2001, the resulting family consisting of the spouse and two children has an out-of-pocket limit of $1,200 ($2,000 − $800 = $1,200) . The remaining out-of-pocket limit for the resulting family consisting of the employee and one child is not subject to the rules of this Q&A–3 because their coverage is not COBRA continuation coverage.

Q–4: Can a qualified beneficiary who elects COBRA continuation coverage ever change from the coverage received by that individual immediately before the qualifying event?

A–4: (a) In general, a qualified beneficiary need only be given an opportunity to continue the coverage that she or he was receiving immediately before the qualifying event. This is true regardless of whether the coverage received by the qualified beneficiary before the qualifying event ceases to be of value to the qualified beneficiary, such as in the case of a qualified beneficiary covered under a region-specific health maintenance organization (HMO) who leaves the HMO's service region. The only situations in which a qualified beneficiary must be allowed to change from the coverage received immediately before the qualifying event are as set forth in paragraphs (b) and (c) of this Q&A–4 and in Q&A–1 of this section (regarding changes to or elimination of the coverage provided to similarly situated nonCOBRA beneficiaries).

(b) If a qualified beneficiary participates in a region-specific benefit package (such as an HMO or an on-site clinic) that will not service her or his health needs in the area to which she or he is relocating (regardless of the reason for the relocation), the qualified

beneficiary must be given, within a reasonable period after requesting other coverage, an opportunity to elect alternative coverage that the employer or employee organization makes available to active employees. If the employer or employee organization makes group health plan coverage available to similarly situated nonCOBRA beneficiaries that can be extended in the area to which the qualified beneficiary is relocating, then that coverage is the alternative coverage that must be made available to the relocating qualified beneficiary. If the employer or employee organization does not make group health plan coverage available to similarly situated nonCOBRA beneficiaries that can be extended in the area to which the qualified beneficiary is relocating but makes coverage available to other employees that can be extended in that area, then the coverage made available to those other employees must be made available to the relocating qualified beneficiary. The effective date of the alternative coverage must be not later than the date of the qualified beneficiary's relocation, or, if later, the first day of the month following the month in which the qualified beneficiary requests the alternative coverage. However, the employer or employee organization is not required to make any other coverage available to the relocating qualified beneficiary if the only coverage the employer or employee organization makes available to active employees is not available in the area to which the qualified beneficiary relocates (because all such coverage is region-specific and does not service individuals in that area).

(c) If an employer or employee organization makes an open enrollment period available to similarly situated active employees with respect to whom a qualifying event has not occurred, the same open enrollment period rights must be made available to each qualified beneficiary receiving COBRA continuation coverage. An open enrollment period means a period during which an employee covered under a plan can choose to be covered under another group health plan or under another benefit package within the same plan, or to add or eliminate coverage of family members.

(d) The rules of this Q&A–4 are illustrated by the following examples:

Example 1. (i) *E* is an employee who works for an employer that maintains several group health plans. Under the terms of the plans, if an employee chooses to cover any family members under a plan, all family members must be covered by the same plan and that plan must be the same as the plan covering the employee. Immediately before *E*'s termination of employment (for reasons other than gross misconduct), *E* is covered along with *E*'s spouse and children by a plan. The coverage under that plan will end as a result of the termination of employment.

(ii) Upon *E*'s termination of employment, each of the four family members is a qualified beneficiary. Even though the employer maintains various other plans and options, it is not necessary for the qualified beneficiaries to be allowed to switch to a new plan when *E* terminates employment.

(iii) COBRA continuation coverage is elected for each of the four family members. Three months after *E*'s termination of employment there is an open enrollment period during which similarly situated active employees are offered an opportunity to choose to be covered under a new plan or to add or eliminate family coverage.

(iv) During the open enrollment period, each of the four qualified beneficiaries must be offered the opportunity to switch to another plan (as though each qualified beneficiary were an individual employee). For example, each member of *E*'s family could choose coverage under a separate plan, even though the family members of employed individuals could not choose coverage under separate plans. Of course, if each family member chooses COBRA continuation coverage under a separate plan, the plan can require payment for each family member that is based on the applicable premium for individual coverage under that separate plan. See Q&A–1 of § 54.4980B–8.

Example 2. (i) The facts are the same as in *Example 1*, except that *E*'s family members are not covered under *E*'s group health plan when *E* terminates employment.

(ii) Although the family members do not have to be given an opportunity to elect COBRA continuation coverage, *E* must be allowed to add them to *E*'s COBRA continuation coverage during the open enrollment period. This is true even though the family members are not, and cannot become, qualified beneficiaries (see Q&A–1 of § 54.4980B–3).

Q–5: Aside from open enrollment periods, can a qualified beneficiary who has elected COBRA continuation coverage choose to cover individuals (such as newborn children, adopted children, or

new spouses) who join the qualified beneficiary's family on or after the date of the qualifying event?

A–5: (a) Yes. Under section 9801, employees eligible to participate in a group health plan (whether or not participating), as well as former employees participating in a plan (referred to in those rules as participants), are entitled to special enrollment rights for certain family members upon the loss of other group health plan coverage or upon the acquisition by the employee or participant of a new spouse or of a new dependent through birth, adoption, or placement for adoption, if certain requirements are satisfied. Employees not participating in the plan also can obtain rights for self-enrollment under those rules. Once a qualified beneficiary is receiving COBRA continuation coverage (that is, has timely elected and made timely payment for COBRA continuation coverage), the qualified beneficiary has the same right to enroll family members under those special enrollment rules as if the qualified beneficiary were an employee or participant within the meaning of those rules. However, neither a qualified beneficiary who is not receiving COBRA continuation coverage nor a former qualified beneficiary has any special enrollment rights under those rules.

(b) In addition to the special enrollment rights described in paragraph (a) of this Q&A–5, if the plan covering the qualified beneficiary provides that new family members of active employees can become covered (either automatically or upon an appropriate election) before the next open enrollment period, then the same right must be extended to the new family members of a qualified beneficiary.

(c) If the addition of a new family member will result in a higher applicable premium (for example, if the qualified beneficiary was previously receiving COBRA continuation coverage as an individual, or if the applicable premium for family coverage depends on family size), the plan can require the payment of a correspondingly higher amount for the COBRA continuation coverage. See Q&A–1 of § 54.4980B–8.

(d) The right to add new family members under this Q&A–5 is in addition to the rights that newborn and adopted children of covered employees may have as qualified beneficiaries; see Q&A–1 in § 54.4980B–3.

[T.D. 8812, 64 FR 5180, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1852, Jan. 10, 2001]

§ 54.4980B–6 Electing COBRA continuation coverage.

The following questions-and-answers address the manner in which COBRA continuation coverage is elected:

Q–1: What is the election period and how long must it last?

A–1: (a) A group health plan can condition the availability of COBRA continuation coverage upon the timely election of such coverage. An election of COBRA continuation coverage is a timely election if it is made during the election period. The election period must begin not later than the date the qualified beneficiary would lose coverage on account of the qualifying event. (See paragraph (c) of Q&A–1 of § 54.4980B–4 for the meaning of *lose coverage*.) The election period must not end before the date that is 60 days after the later of—

(1) The date the qualified beneficiary would lose coverage on account of the qualifying event; or

(2) The date notice is provided to the qualified beneficiary of her or his right to elect COBRA continuation coverage.

(b) An election is considered to be made on the date it is sent to the plan administrator.

(c) The rules of this Q&A–1 are illustrated by the following example:

Example. (i) An unmarried employee without children who is receiving employer-paid coverage under a group health plan voluntarily terminates employment on June 1, 2001. The employee is not disabled at the time of the termination of employment nor at any time thereafter, and the plan does not provide for the extension of the required periods (as is permitted under paragraph (b) of Q&A–4 of § 54.4980B–7).

(ii) *Case 1:* If the plan provides that the employer-paid coverage ends immediately upon the termination of employment, the election period must begin not later than June 1, 2001, and must not end earlier than July 31, 2001. If notice of the right to elect COBRA continuation coverage is not provided to the employee until June 15, 2001, the election period must not end earlier than August 14, 2001.

(iii) *Case 2:* If the plan provides that the employer-paid coverage does not end until 6

months after the termination of employment, the employee does not lose coverage until December 1, 2001. The election period can therefore begin as late as December 1, 2001, and must not end before January 30, 2002.

(iv) *Case 3:* If employer-paid coverage for 6 months after the termination of employment is offered only to those qualified beneficiaries who waive COBRA continuation coverage, the employee loses coverage on June 1, 2001, so the election period is the same as in Case 1. The difference between Case 2 and Case 3 is that in Case 2 the employee can receive 6 months of employer-paid coverage and then elect to pay for up to an additional 12 months of COBRA continuation coverage, while in Case 3 the employee must choose between 6 months of employer-paid coverage and paying for up to 18 months of COBRA continuation coverage. In all three cases, COBRA continuation coverage need not be provided for more than 18 months after the termination of employment (see Q&A–4 of § 54.4980B–7), and in certain circumstances might be provided for a shorter period (see Q&A–1 of § 54.4980B–7).

Q–2: Is a covered employee or qualified beneficiary responsible for informing the plan administrator of the occurrence of a qualifying event?

A–2: (a) In general, the employer or plan administrator must determine when a qualifying event has occurred. However, each covered employee or qualified beneficiary is responsible for notifying the plan administrator of the occurrence of a qualifying event that is either a dependent child's ceasing to be a dependent child under the generally applicable requirements of the plan or a divorce or legal separation of a covered employee. The group health plan is not required to offer the qualified beneficiary an opportunity to elect COBRA continuation coverage if the notice is not provided to the plan administrator within 60 days after the later of—

(1) The date of the qualifying event; or

(2) The date the qualified beneficiary would lose coverage on account of the qualifying event.

(b) For purposes of this Q&A–2, if more than one qualified beneficiary would lose coverage on account of a divorce or legal separation of a covered employee, a timely notice of the divorce or legal separation that is provided by the covered employee or any one of those qualified beneficiaries will be sufficient to preserve the election rights of all of the qualified beneficiaries.

Q–3: During the election period and before the qualified beneficiary has made an election, must coverage be provided?

A–3: (a) In general, each qualified beneficiary has until 60 days after the later of the date the qualifying event would cause her or him to lose coverage or the date notice is provided to the qualified beneficiary of her or his right to elect COBRA continuation coverage to decide whether to elect COBRA continuation coverage. If the election is made during that period, coverage must be provided from the date that coverage would otherwise have been lost (but see Q&A–4 of this section). This can be accomplished as described in paragraph (b) or (c) of this Q&A–3.

(b) In the case of an indemnity or reimbursement arrangement, the employer or employee organization can provide for plan coverage during the election period or, if the plan allows retroactive reinstatement, the employer or employee organization can terminate the coverage of the qualified beneficiary and reinstate her or him when the election (and, if applicable, payment for the coverage) is made. Claims incurred by a qualified beneficiary during the election period do not have to be paid before the election (and, if applicable, payment for the coverage) is made. If a provider of health care (such as a physician, hospital, or pharmacy) contacts the plan to confirm coverage of a qualified beneficiary during the election period, the plan must give a complete response to the health care provider about the qualified beneficiary's COBRA continuation coverage rights during the election period. For example, if the plan provides coverage during the election period but cancels coverage retroactively if COBRA continuation coverage is not elected, then the plan must inform a provider that a qualified beneficiary for whom coverage has not been elected is covered but that the coverage is subject to retroactive termination. Similarly, if the plan cancels coverage but then retroactively reinstates it once COBRA continuation

coverage is elected, then the plan must inform the provider that the qualified beneficiary currently does not have coverage but will have coverage retroactively to the date coverage was lost if COBRA continuation coverage is elected. (See paragraph (c) of Q&A–5 in § 54.4980B–8 for similar rules that a plan must follow in confirming coverage during a period when the plan has not received payment but that is still within the grace period for a qualified beneficiary for whom COBRA continuation coverage has been elected.)

(c)(1) In the case of a group health plan that provides health services (such as a health maintenance organization or a walk-in clinic), the plan can require with respect to a qualified beneficiary who has not elected and paid for COBRA continuation coverage that the qualified beneficiary choose between—

(i) Electing and paying for the coverage; or

(ii) Paying the reasonable and customary charge for the plan's services, but only if a qualified beneficiary who chooses to pay for the services will be reimbursed for that payment within 30 days after the election of COBRA continuation coverage (and, if applicable, the payment of any balance due for the coverage).

(2) In the alternative, the plan can provide continued coverage and treat the qualified beneficiary's use of the facility as a constructive election. In such a case, the qualified beneficiary is obligated to pay any applicable charge for the coverage, but only if the qualified beneficiary is informed that use of the facility will be a constructive election before using the facility.

Q–4: Is a waiver before the end of the election period effective to end a qualified beneficiary's election rights?

A–4: If, during the election period, a qualified beneficiary waives COBRA continuation coverage, the waiver can be revoked at any time before the end of the election period. Revocation of the waiver is an election of COBRA continuation coverage. However, if a waiver of COBRA continuation coverage is later revoked, coverage need not be provided retroactively (that is, from the date of the loss of coverage until the waiver is revoked). Waivers and revocations of waivers are considered made on the date they are sent to the employer, employee organization, or plan administrator, as applicable.

Q–5: Can an employer or employee organization withhold money or other benefits owed to a qualified beneficiary until the qualified beneficiary either waives COBRA continuation coverage, elects and pays for such coverage, or allows the election period to expire?

A–5: No. An employer, and an employee organization, must not withhold anything to which a qualified beneficiary is otherwise entitled (by operation of law or other agreement) in order to compel payment for COBRA continuation coverage or to coerce the qualified beneficiary to give up rights to COBRA continuation coverage (including the right to use the full election period to decide whether to elect such coverage). Such a withholding constitutes a failure to comply with the COBRA continuation coverage requirements. Furthermore, any purported waiver obtained by means of such a withholding is invalid.

Q–6: Can each qualified beneficiary make an independent election under COBRA?

A–6: Yes. Each qualified beneficiary (including a child who is born to or placed for adoption with a covered employee during a period of COBRA continuation coverage) must be offered the opportunity to make an independent election to receive COBRA continuation coverage. If the plan allows similarly situated active employees with respect to whom a qualifying event has not occurred to choose among several options during an open enrollment period (for example, to switch to another group health plan or to another benefit package under the same group health plan), then each qualified beneficiary must also be offered an independent election to choose during an open enrollment period among the options made available to similarly situated active employees with respect to whom a qualifying event has not occurred. If a qualified beneficiary who is either a covered employee or the spouse of a covered employee elects COBRA continuation coverage and the election does not specify whether the election is for self-only coverage, the election is

deemed to include an election of COBRA continuation coverage on behalf of all other qualified beneficiaries with respect to that qualifying event. An election on behalf of a minor child can be made by the child's parent or legal guardian. An election on behalf of a qualified beneficiary who is incapacitated or dies can be made by the legal representative of the qualified beneficiary or the qualified beneficiary's estate, as determined under applicable state law, or by the spouse of the qualified beneficiary. (See also Q&A–5 of § 54.4980B–7 relating to the independent right of each qualified beneficiary with respect to the same qualifying event to receive COBRA continuation coverage during the disability extension.) The rules of this Q&A–6 are illustrated by the following examples; in each example each group health plan is subject to COBRA:

Example 1. (i) Employee *H* and *H*'s spouse are covered under a group health plan immediately before *H*'s termination of employment (for reasons other than gross misconduct). Coverage under the plan will end as a result of the termination of employment.

(ii) Upon *H*'s termination of employment, both *H* and *H*'s spouse are qualified beneficiaries and each must be allowed to elect COBRA continuation coverage. Thus, *H* might elect COBRA continuation coverage while the spouse declines to elect such coverage, or *H* might elect COBRA continuation coverage for both of them. In contrast, *H* cannot decline COBRA continuation coverage on behalf of *H*'s spouse. Thus, if *H* does not elect COBRA continuation coverage on behalf of the spouse, the spouse must still be allowed to elect COBRA continuation coverage.

Example 2. (i) An employer maintains a group health plan under which all employees receive employer-paid coverage. Employees can arrange to cover their families by paying an additional amount. The employer also maintains a cafeteria plan, under which one of the options is to pay part or all of the employee share of the cost for family coverage under the group health plan. Thus, an employee might pay for family coverage under the group health plan partly with before-tax dollars and partly with after-tax dollars.

(ii) If an employee's family is receiving coverage under the group health plan when a qualifying event occurs, each of the qualified beneficiaries must be offered an opportunity to elect COBRA continuation coverage, regardless of how that qualified beneficiary's coverage was paid for before the qualifying event.

[T.D. 8812, 64 FR 5182, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1853, Jan. 10, 2001]

§ 54.4980B–7 Duration of COBRA continuation coverage.

The following questions-and-answers address the duration of COBRA continuation coverage:

Q–1: How long must COBRA continuation coverage be made available to a qualified beneficiary?

A–1: (a) Except for an interruption of coverage in connection with a waiver, as described in Q&A–4 of § 54.4980B–6, COBRA continuation coverage that has been elected for a qualified beneficiary must extend for at least the period beginning on the date of the qualifying event and ending not before the earliest of the following dates—

(1) The last day of the maximum coverage period (see Q&A–4 of this section);

(2) The first day for which timely payment is not made to the plan with respect to the qualified beneficiary (see Q&A–5 in § 54.4980B–8);

(3) The date upon which the employer or employee organization ceases to provide any group health plan (including successor plans) to any employee;

(4) The date, after the date of the election, upon which the qualified beneficiary first becomes covered under any other group health plan, as described in Q&A–2 of this section;

(5) The date, after the date of the election, upon which the qualified beneficiary first becomes entitled to Medicare benefits, as described in Q&A–3 of this section; and

(6) In the case of a qualified beneficiary entitled to a disability extension (see Q&A–5 of this section), the later of—

(i) Either 29 months after the date of the qualifying event, or the first day of the month that is more than 30 days after the date of a final determination under Title II or XVI of the Social Security Act (42 U.S.C. 401–433 or 1381–1385) that the disabled qualified beneficiary whose disability resulted in the qualified beneficiary's being entitled to the disability extension is no longer disabled, whichever is earlier; or

(ii) The end of the maximum coverage period that applies to the qualified beneficiary without regard to the disability extension.

(b) However, a group health plan can terminate for cause the coverage of a qualified beneficiary receiving COBRA continuation coverage on the same basis that the plan terminates for cause the coverage of similarly situated nonCOBRA beneficiaries. For example, if a group health plan terminates the coverage of active employees for the submission of a fraudulent claim, then the coverage of a qualified beneficiary can also be terminated for the submission of a fraudulent claim. Notwithstanding the preceding two sentences, the coverage of a qualified beneficiary can be terminated for failure to make timely payment to the plan only if payment is not timely under the rules of Q&A–5 in § 54.4980B–8.

(c) In the case of an individual who is not a qualified beneficiary and who is receiving coverage under a group health plan solely because of the individual's relationship to a qualified beneficiary, if the plan's obligation to make COBRA continuation coverage available to the qualified beneficiary ceases under this section, the plan is not obligated to make coverage available to the individual who is not a qualified beneficiary.

Q–2: When may a plan terminate a qualified beneficiary's COBRA continuation coverage due to coverage under another group health plan?

A–2: (a) If a qualified beneficiary first becomes covered under another group health plan (including for this purpose any group health plan of a governmental employer or employee organization) after the date on which COBRA continuation coverage is elected for the qualified beneficiary and the other coverage satisfies the requirements of paragraphs (b), (c), and (d) of this Q&A–2, then the plan may terminate the qualified beneficiary's COBRA continuation coverage upon the date on which the qualified beneficiary first becomes covered under the other group health plan (even if the other coverage is less valuable to the qualified beneficiary). By contrast, if a qualified beneficiary first becomes covered under another group health plan on or before the date on which COBRA continuation coverage is elected, then the other coverage cannot be a basis for terminating the qualified beneficiary's COBRA continuation coverage.

(b) The requirement of this paragraph (b) is satisfied if the qualified beneficiary is actually covered, rather than merely eligible to be covered, under the other group health plan.

(c) The requirement of this paragraph (c) is satisfied if the other group health plan is a plan that is not maintained by the employer or employee organization that maintains the plan under which COBRA continuation coverage must otherwise be made available.

(d) The requirement of this paragraph (d) is satisfied if the other group health plan does not contain any exclusion or limitation with respect to any preexisting condition of the qualified beneficiary (other than such an exclusion or limitation that does not apply to, or is satisfied by, the qualified beneficiary by reason of the provisions in section 9801 (relating to limitations on preexisting condition exclusion periods in group health plans)).

(e) The rules of this Q&A–2 are illustrated by the following examples:

Example 1. (i) Employer *X* maintains a group health plan subject to COBRA. *C* is an employee covered under the plan. *C* is also covered under a group health plan maintained by Employer *Y*, the employer of *C*'s spouse. *C* terminates employment (for reasons other than gross misconduct), and the termination of employment causes *C* to lose coverage under *X*'s plan (and, thus, is a qualifying event). *C* elects to receive COBRA continuation coverage under *X*'s plan.

(ii) Under these facts, *X*'s plan cannot terminate *C*'s COBRA continuation coverage on the basis of *C*'s coverage under *Y*'s plan.

Example 2. (i) Employer *W* maintains a group health plan subject to COBRA. *D* is an employee covered under the plan. *D* terminates employment (for reasons other than gross misconduct), and the termination of employment causes *D* to lose coverage under *W*'s plan (and, thus, is a qualifying event). *D* elects to receive COBRA continuation coverage under *W*'s plan. Later *D* becomes employed by Employer *V* and is covered under *V*'s group health plan. *D*'s coverage under *V*'s plan is not subject to any exclusion or limitation with respect to any preexisting condition of *D*.

(ii) Under these facts, *W* can terminate *D*'s COBRA continuation coverage on the date *D* becomes covered under *V*'s plan.

Example 3. (i) The facts are the same as in *Example 2*, except that *D* becomes employed by *V* and becomes covered under *V*'s group health plan before *D* elects COBRA continuation coverage under *W*'s plan.

(ii) Because the termination of employment is a qualifying event, *D* must be offered COBRA continuation coverage under *W*'s plan, and *W* is not permitted to terminate *D*'s COBRA continuation coverage on account of *D*'s coverage under *V*'s plan because *D* first became covered under *V*'s plan before COBRA continuation coverage was elected for *D*.

Q–3: When may a plan terminate a qualified beneficiary's COBRA continuation coverage due to the qualified beneficiary's entitlement to Medicare benefits?

A–3: (a) If a qualified beneficiary first becomes entitled to Medicare benefits under Title XVIII of the Social Security Act (42 U.S.C. 1395–1395ggg) after the date on which COBRA continuation coverage is elected for the qualified beneficiary, then the plan may terminate the qualified beneficiary's COBRA continuation coverage upon the date on which the qualified beneficiary becomes so entitled. By contrast, if a qualified beneficiary first becomes entitled to Medicare benefits on or before the date that COBRA continuation coverage is elected, then the qualified beneficiary's entitlement to Medicare benefits cannot be a basis for terminating the qualified beneficiary's COBRA continuation coverage.

(b) A qualified beneficiary becomes entitled to Medicare benefits upon the effective date of enrollment in either part A or B, whichever occurs earlier. Thus, merely being eligible to enroll in Medicare does not constitute being entitled to Medicare benefits.

Q–4: When does the maximum coverage period end?

A–4: (a) Except as otherwise provided in this Q&A–4, the maximum coverage period ends 36 months after the qualifying event. The maximum coverage period for a qualified beneficiary who is a child born to or placed for adoption with a covered employee during a period of COBRA continuation coverage is the maximum coverage period for the qualifying event giving rise to the period of COBRA continuation coverage during which the child was born or placed for adoption. Paragraph (b) of this Q&A–4 describes the starting point from which the end of the maximum coverage period is measured. The date that the maximum coverage period ends is described in paragraph (c) of this Q&A–4 in a case where the qualifying event is a termination of employment or reduction of hours of employment, in paragraph (d) of this Q&A–4 in a case where a covered employee becomes entitled to Medicare benefits under Title XVIII of the Social Security Act (42 U.S.C. 1395–1395ggg) before experiencing a qualifying event that is a termination of employment or reduction of hours of employment, and in paragraph (e) of this Q&A–4 in the case of a qualifying event that is the bankruptcy of the employer. See Q&A–8 of § 54.4980B–2 for limitations that apply to certain health flexible spending arrangements. See also Q&A–6 of this section in the case of multiple qualifying events. Nothing in §§ 54.4980B–1 through 54.4980B–10 prohibits a group health plan from providing coverage that continues beyond the end of the maximum coverage period.

(b)(1) The end of the maximum coverage period is measured from the date of the qualifying event even if the qualifying event does not result in a loss of coverage under the plan until a later date. If, however, coverage under the plan is lost at a later date and the plan provides for the extension of the required periods, then the maximum coverage period is measured from the date when coverage is lost. A plan provides for the extension of the required periods if it provides both—

(i) That the 30-day notice period (during which the employer is required to notify the plan administrator of the occurrence of certain qualifying events such as the death of the covered employee or the termination of employment or reduction of hours of employment of the covered employee) begins on the date of the loss of coverage rather than on the date of the qualifying event; and

(ii) That the end of the maximum coverage period is measured from the date of the loss of coverage rather than from the date of the qualifying event.

(2) In the case of a plan that provides for the extension of the required periods, whenever the rules of §§ 54.4980B–1 through 54.4980B–10 refer to the measurement of a period from the date of the qualifying event, those rules apply in such a case by measuring the period instead from the date of the loss of coverage.

(c) In the case of a qualifying event that is a termination of employment or reduction of hours of employment, the maximum coverage period ends 18 months after the qualifying event if there is no disability extension, and 29 months after the qualifying event if there is a disability extension. See Q&A–5 of this section for rules to determine if there is a disability extension. If there is a disability extension and the disabled qualified beneficiary is later determined to no longer be disabled, then a plan may terminate the COBRA continuation coverage of an affected qualified beneficiary before the end of the disability extension; see paragraph (a)(6) in Q&A–1 of this section.

(d)(1) If a covered employee becomes entitled to Medicare benefits under Title XVIII of the Social Security Act (42 U.S.C. 1395–1395ggg) before experiencing a qualifying event that is a termination of employment or reduction of hours of employment, the maximum coverage period for qualified beneficiaries other than the covered employee ends on the later of—

(i) 36 months after the date the covered employee became entitled to Medicare benefits; or

(ii) 18 months (or 29 months, if there is a disability extension) after the date of the covered employee's termination of employment or reduction of hours of employment.

(2) See paragraph (b) of Q&A–3 of this section regarding the determination of when a covered employee becomes entitled to Medicare benefits.

(e) In the case of a qualifying event that is the bankruptcy of the employer, the maximum coverage period for a qualified beneficiary who is the retired covered employee ends on the date of the retired covered employee's death. The maximum coverage period for a qualified beneficiary who is the spouse, surviving spouse, or dependent child of the retired covered employee ends on the earlier of—

(1) The date of the qualified beneficiary's death; or

(2) The date that is 36 months after the death of the retired covered employee.

Q–5: How does a qualified beneficiary become entitled to a disability extension?

A–5: (a) A qualified beneficiary becomes entitled to a disability extension if the requirements of paragraphs (b), (c), and (d) of this Q&A–5 are satisfied with respect to the qualified beneficiary. If the disability extension applies with respect to a qualifying event, it applies with respect to each qualified beneficiary entitled to COBRA continuation coverage because of that qualifying event. Thus, for example, the 29-month maximum coverage period applies to each qualified beneficiary who is not disabled as well as to the qualified beneficiary who is disabled, and it applies independently with respect to each of the qualified beneficiaries. See Q&A–1 in § 54.4980B–8, which permits a plan to require payment of an increased amount during the disability extension.

(b) The requirement of this paragraph (b) is satisfied if a qualifying event occurs that is a termination, or reduction of hours, of a covered employee's employment.

(c) The requirement of this paragraph (c) is satisfied if an individual (whether or not the covered employee) who is a qualified beneficiary in connection with the qualifying event described in paragraph (b) of this Q&A–5 is determined under Title II or XVI of the Social Security Act (42 U.S.C. 401–433 or 1381–1385) to have been disabled at any time during the first 60 days of COBRA continuation coverage. For this purpose, the period of the first 60 days of COBRA continuation coverage is measured from the date of the qualifying event described in paragraph (b) of this Q&A–5 (except that if a loss of coverage would occur at a later date in the absence of an election for COBRA continuation coverage and if the plan provides for the extension of the required periods (as described in paragraph (b)

of Q&A–4 of this section) then the period of the first 60 days of COBRA continuation coverage is measured from the date on which the coverage would be lost). However, in the case of a qualified beneficiary who is a child born to or placed for adoption with a covered employee during a period of COBRA continuation coverage, the period of the first 60 days of COBRA continuation coverage is measured from the date of birth or placement for adoption. For purposes of this paragraph (c), an individual is determined to be disabled within the first 60 days of COBRA continuation coverage if the individual has been determined under Title II or XVI of the Social Security Act to have been disabled before the first day of COBRA continuation coverage and has not been determined to be no longer disabled at any time between the date of that disability determination and the first day of COBRA continuation coverage.

(d) The requirement of this paragraph (d) is satisfied if any of the qualified beneficiaries affected by the qualifying event described in paragraph (b) of this Q&A–5 provides notice to the plan administrator of the disability determination on a date that is both within 60 days after the date the determination is issued and before the end of the original 18-month maximum coverage period that applies to the qualifying event.

Q–6: Under what circumstances can the maximum coverage period be expanded?

A–6: (a) The maximum coverage period can be expanded if the requirements of Q&A–5 of this section (relating to the disability extension) or paragraph (b) of this Q&A–6 are satisfied.

(b) The requirements of this paragraph (b) are satisfied if a qualifying event that gives rise to an 18-month maximum coverage period (or a 29-month maximum coverage period in the case of a disability extension) is followed, within that 18-month period (or within that 29-month period, in the case of a disability extension), by a second qualifying event (for example, a death or a divorce) that gives rise to a 36-month maximum coverage period. (Thus, a termination of employment following a qualifying event that is a reduction of hours of employment cannot be a second qualifying event that expands the maximum coverage period; the bankruptcy of an employer also cannot be a second qualifying event that expands the maximum coverage period.) In such a case, the original 18-month period (or 29-month period, in the case of a disability extension) is expanded to 36 months, but only for those individuals who were qualified beneficiaries under the group health plan in connection with the first qualifying event and who are still qualified beneficiaries at the time of the second qualifying event. No qualifying event (other than a qualifying event that is the bankruptcy of the employer) can give rise to a maximum coverage period that ends more than 36 months after the date of the first qualifying event (or more than 36 months after the date of the loss of coverage, in the case of a plan that provides for the extension of the required periods; see paragraph (b) in Q&A–4 of this section). For example, if an employee covered by a group health plan that is subject to COBRA terminates employment (for reasons other than gross misconduct) on December 31, 2000, the termination is a qualifying event giving rise to a maximum coverage period that extends for 18 months to June 30, 2002. If the employee dies after the employee and the employee's spouse and dependent children have elected COBRA continuation coverage and on or before June 30, 2002, the spouse and dependent children (except anyone among them whose COBRA continuation coverage had already ended for some other reason) will be able to receive COBRA continuation coverage through December 31, 2003. See Q&A–8(b) of § 54.4980B–2 for a special rule that applies to certain health flexible spending arrangements.

Q–7: If health coverage is provided to a qualified beneficiary after a qualifying event without regard to COBRA continuation coverage (for example, as a result of state or local law, the Uniformed Services Employment and Reemployment Rights Act of 1994 (38 U.S.C. 4315), industry practice, a collective bargaining agreement, severance agreement, or plan procedure), will such alternative coverage extend the maximum coverage period?

A–7: (a) No. The end of the maximum coverage period is measured solely as described in Q&A–4 and Q&A–6 of this section, which is generally from the date of the qualifying event.

(b) If the alternative coverage does not satisfy all the requirements for COBRA continuation coverage, or if the amount that the group health plan requires to be paid for the alternative coverage is greater than the amount required to be paid by similarly situated nonCOBRA beneficiaries for the coverage that the qualified beneficiary can elect to receive as COBRA continuation coverage, the plan covering the qualified beneficiary immediately before the qualifying event must offer the qualified beneficiary receiving the alternative coverage the opportunity to elect COBRA continuation coverage. See Q&A–1 of § 54.4980B–6.

(c) If an individual rejects COBRA continuation coverage in favor of alternative coverage, then, at the expiration of the alternative coverage period, the individual need not be offered a COBRA election. However, if the individual receiving alternative coverage is a covered employee and the spouse or a dependent child of the individual would lose that alternative coverage as a result of a qualifying event (such as the death of the covered employee), the spouse or dependent child must be given an opportunity to elect to continue that alternative coverage, with a maximum coverage period of 36 months measured from the date of that qualifying event.

Q–8: Must a qualified beneficiary be given the right to enroll in a conversion health plan at the end of the maximum coverage period for COBRA continuation coverage?

A–8: If a qualified beneficiary's COBRA continuation coverage under a group health plan ends as a result of the expiration of the maximum coverage period, the group health plan must, during the 180-day period that ends on that expiration date, provide the qualified beneficiary the option of enrolling under a conversion health plan if such an option is otherwise generally available to similarly situated nonCOBRA beneficiaries under the group health plan. If such a conversion option is not otherwise generally available, it need not be made available to qualified beneficiaries.

[T.D. 8812, 64 FR 5184, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1853, Jan. 10, 2001]

§ 54.4980B–8 Paying for COBRA continuation coverage.

The following questions-and-answers address paying for COBRA continuation coverage:

Q–1: Can a group health plan require payment for COBRA continuation coverage?

A–1: (a) Yes. For any period of COBRA continuation coverage, a group health plan can require the payment of an amount that does not exceed 102 percent of the applicable premium for that period. (See paragraph (b) of this Q&A–1 for a rule permitting a plan to require payment of an increased amount due to the disability extension.) The applicable premium is defined in section 4980B(f)(4). A group health plan can terminate a qualified beneficiary's COBRA continuation coverage as of the first day of any period for which timely payment is not made to the plan with respect to that qualified beneficiary (see Q&A–1 of § 54.4980B–7). For the meaning of *timely payment*, see Q&A–5 of this section.

(b) A group health plan is permitted to require the payment of an amount that does not exceed 150 percent of the applicable premium for any period of COBRA continuation coverage covering a disabled qualified beneficiary (for example, whether single or family coverage) if the coverage would not be required to be made available in the absence of a disability extension. (See Q&A–5 of § 54.4980B–7 for rules to determine whether a qualified beneficiary is entitled to a disability extension.) A plan is not permitted to require the payment of an amount that exceeds 102 percent of the applicable premium for any period of COBRA continuation coverage to which a qualified beneficiary is entitled without regard to the disability extension. Thus, if a qualified beneficiary entitled to a disability extension experiences a second qualifying event within the original 18-month maximum coverage period, then the plan is not permitted to require the payment of an amount that exceeds 102 percent of the applicable premium for

any period of COBRA continuation coverage. By contrast, if a qualified beneficiary entitled to a disability extension experiences a second qualifying event after the end of the original 18-month maximum coverage period, then the plan may require the payment of an amount that is up to 150 percent of the applicable premium for the remainder of the period of COBRA continuation coverage (that is, from the beginning of the 19th month through the end of the 36th month) as long as the disabled qualified beneficiary is included in that coverage. The rules of this paragraph (b) are illustrated by the following examples; in each example the group health plan is subject to COBRA:

Example 1. (i) An employer maintains a group health plan. The plan determines the cost of covering individuals under the plan by reference to two categories, individual coverage and family coverage, and the applicable premium is determined for those two categories. An employee and members of the employee's family are covered under the plan. The employee experiences a qualifying event that is the termination of the employee's employment. The employee's family qualifies for the disability extension because of the disability of the employee's spouse. (Timely notice of the disability is provided to the plan administrator.) Timely payment of the amount required by the plan for COBRA continuation coverage for the family (which does not exceed 102 percent of the cost of family coverage under the plan) was made to the plan with respect to the employee's family for the first 18 months of COBRA continuation coverage, and the disabled spouse and the rest of the family continue to receive COBRA continuation coverage through the 29th month.

(ii) Under these facts, the plan may require payment of up to 150 percent of the applicable premium for family coverage in order for the family to receive COBRA continuation coverage from the 19th month through the 29th month. If the plan determined the cost of coverage by reference to three categories (such as employee, employee-plus-one-dependent, employee-plus-two-or-more-dependents) or more than three categories, instead of two categories, the plan could still require, from the 19th month through the 29th month of COBRA continuation coverage, the payment of 150 percent of the cost of coverage for the category of coverage that included the disabled spouse.

Example 2. (i) The facts are the same as in *Example 1*, except that only the covered employee elects and pays for the first 18 months of COBRA continuation coverage.

(ii) Even though the employee's disabled spouse does not elect or pay for COBRA continuation coverage, the employee satisfies the requirements for the disability extension to apply with respect to the employee's qualifying event. Under these facts, the plan may not require the payment of more than 102 percent of the applicable premium for individual coverage for the entire period of the employee's COBRA continuation coverage, including the period from the 19th month through the 29th month. If COBRA continuation coverage had been elected and paid for with respect to other nondisabled members of the employee's family, then the plan could not require the payment of more than 102 percent of the applicable premium for family coverage (or for any other appropriate category of coverage that might apply to that group of qualified beneficiaries under the plan, such as employee-plus-one-dependent or employee-plus-two-or-more-dependents) for those family members to continue their coverage from the 19th month through the 29th month.

(c) A group health plan does not fail to comply with section 9802(b) (which generally prohibits an individual from being charged, on the basis of health status, a higher premium than that charged for similarly situated individuals enrolled in the plan) with respect to a qualified beneficiary entitled to the disability extension merely because the plan requires payment of an amount permitted under paragraph (b) of this Q&A–1.

Q–2: When is the applicable premium determined and when can a group health plan increase the amount it requires to be paid for COBRA continuation coverage?

A–2: (a) The applicable premium for each determination period must be computed and fixed by a group health plan before the determination period begins. A determination period is any 12-month period selected by the plan, but it must be applied consistently from year to year. The determination period is a single period for any benefit package. Thus, each qualified beneficiary does not have a separate determination period beginning on the date (or anniversaries of the date) that COBRA continuation coverage begins for that qualified beneficiary.

(b) During a determination period, a plan can increase the amount it requires to be paid for a qualified beneficiary's COBRA continuation coverage only in the following three cases:

(1) The plan has previously charged less than the maximum amount permitted under Q&A–1 of this section and the increased amount required to be paid does not exceed the maximum amount permitted under Q&A–1 of this section;

(2) The increase occurs during the disability extension and the increased amount required to be paid does not exceed the maximum amount permitted under paragraph (b) of Q&A–1 of this section; or

(3) A qualified beneficiary changes the coverage being received (see paragraph (c) of this Q&A–2 for rules on how the amount the plan requires to be paid may or must change when a qualified beneficiary changes the coverage being received).

(c) If a plan allows similarly situated active employees who have not experienced a qualifying event to change the coverage they are receiving, then the plan must also allow each qualified beneficiary to change the coverage being received on the same terms as the similarly situated active employees. (See Q&A–4 in § 54.4980B–5.) If a qualified beneficiary changes coverage from one benefit package (or a group of benefit packages) to another benefit package (or another group of benefit packages), or adds or eliminates coverage for family members, then the following rules apply. If the change in coverage is to a benefit package, group of benefit packages, or coverage unit (such as family coverage, self-plus-one-dependent, or self-plus-two-or-more-dependents) for which the applicable premium is higher, then the plan may increase the amount that it requires to be paid for COBRA continuation coverage to an amount that does not exceed the amount permitted under Q&A–1 of this section as applied to the new coverage. If the change in coverage is to a benefit package, group of benefit packages, or coverage unit (such as individual or self-plus-one-dependent) for which the applicable premium is lower, then the plan cannot require the payment of an amount that exceeds the amount permitted under Q&A–1 of this section as applied to the new coverage.

Q–3: Must a plan allow payment for COBRA continuation coverage to be made in monthly installments?

A–3: Yes. A group health plan must allow payment for COBRA continuation coverage to be made in monthly installments. A group health plan is permitted to also allow the alternative of payment for COBRA continuation coverage being made at other intervals (for example, weekly, quarterly, or semiannually).

Q–4: Is a plan required to allow a qualified beneficiary to choose to have the first payment for COBRA continuation coverage applied prospectively only?

A–4: No. A plan is permitted to apply the first payment for COBRA continuation coverage to the period of coverage beginning immediately after the date on which coverage under the plan would have been lost on account of the qualifying event. Of course, if the group health plan allows a qualified beneficiary to waive COBRA continuation coverage for any period before electing to receive COBRA continuation coverage, the first payment is not applied to the period of the waiver.

Q–5: What is timely payment for COBRA continuation coverage?

A–5: (a) Except as provided in this paragraph (a) or in paragraph (b) or (d) of this Q&A–5, timely payment for a period of COBRA continuation coverage under a group health plan means payment that is made to the plan by the date that is 30 days after the first day of that period. Payment that is made to the plan by a later date is also considered timely payment if either—

(1) Under the terms of the plan, covered employees or qualified beneficiaries are allowed until that later date to pay for their coverage for the period; or

(2) Under the terms of an arrangement between the employer or employee organization and an insurance company, health maintenance organization, or other entity that provides plan benefits on the employer's or employee organization's behalf, the employer or employee organization is allowed until that later date to pay for coverage of similarly situated nonCOBRA beneficiaries for the period.

(b) Notwithstanding paragraph (a) of this Q&A–5, a plan cannot require payment for any period of COBRA continuation coverage for a qualified beneficiary earlier than 45 days after the date on which the election of COBRA continuation coverage is made for that qualified beneficiary.

(c) If, after COBRA continuation coverage has been elected for a qualified beneficiary, a provider of health care (such as a physician, hospital, or pharmacy) contacts the plan to confirm coverage of a qualified beneficiary for a period for which the plan has not yet received payment, the plan must give a complete response to the health care provider about the qualified beneficiary's COBRA continuation coverage rights, if any, described in paragraphs (a), (b), and (d) of this Q&A–5. For example, if the plan provides coverage during the 30- and 45-day grace periods described in paragraphs (a) and (b) of this Q&A–5 but cancels coverage retroactively if payment is not made by the end of the applicable grace period, then the plan must inform a provider with respect to a qualified beneficiary for whom payment has not been received that the qualified beneficiary is covered but that the coverage is subject to retroactive termination if timely payment is not made. Similarly, if the plan cancels coverage if it has not received payment by the first day of a period of coverage but retroactively reinstates coverage if payment is made by the end of the grace period for that period of coverage, then the plan must inform the provider that the qualified beneficiary currently does not have coverage but will have coverage retroactively to the first date of the period if timely payment is made. (See paragraph (b) of Q&A–3 in § 54.4980B–6 for similar rules that the plan must follow in confirming coverage during the election period.)

(d) If timely payment is made to the plan in an amount that is not significantly less than the amount the plan requires to be paid for a period of coverage, then the amount paid is deemed to satisfy the plan's requirement for the amount that must be paid, unless the plan notifies the qualified beneficiary of the amount of the deficiency and grants a reasonable period of time for payment of the deficiency to be made. For this purpose, as a safe harbor, 30 days after the date the notice is provided is deemed to be a reasonable period of time. An amount is not significantly less than the amount the plan requires to be paid for a period of coverage if and only if the shortfall is no greater than the lesser of the following two amounts:

(1) Fifty dollars (or such other amount as the Commissioner may provide in a revenue ruling, notice, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter)); or

(2) 10 percent of the amount the plan requires to be paid.

(e) Payment is considered made on the date on which it is sent to the plan.

[T.D. 8812, 64 FR 5186, Feb. 3, 1999, as amended by T.D. 8928, 66 FR 1854, Jan. 10, 2001]

§ 54.4980B–9 Business reorganizations and employer withdrawals from multiemployer plans.

The following questions-and-answers address who has the obligation to make COBRA continuation coverage available to affected qualified beneficiaries in the context of business reorganizations and employer withdrawals from multiemployer plans:

Q–1: For purposes of this section, what are a business reorganization, a stock sale, and an asset sale?

A–1: For purposes of this section:

(a) A *business reorganization* is a stock sale or an asset sale.

(b) A *stock sale* is a transfer of stock in a corporation that causes the corporation to become a different employer or a member of a different employer. (See Q&A–2 of § 54.4980B–2, which defines *employer* to include all members of a controlled group of corporations.) Thus, for example, a sale or distribution of stock in a corporation that causes the corporation to cease to be a member of one controlled group of corporations, whether or not it becomes a member of another controlled group of corporations, is a stock sale.

(c) An *asset sale* is a transfer of substantial assets, such as a plant or division or substantially all the assets of a trade or business.

(d) The rules of §1.414(b)–1 of this chapter apply in determining what constitutes a controlled group of corporations, and the rules of §§1.414(c)–1 through 1.414(c)–5 of this chapter apply in determining what constitutes a group of trades or businesses under common control.

Q–2: In the case of a stock sale, what are the selling group, the acquired organization, and the buying group?

A–2: In the case of a stock sale—

(a) The *selling group* is the controlled group of corporations, or the group of trades or businesses under common control, of which a corporation ceases to be a member as a result of the stock sale;

(b) The *acquired organization* is the corporation that ceases to be a member of the selling group as a result of the stock sale; and

(c) The *buying group* is the controlled group of corporations, or the group of trades or businesses under common control, of which the acquired organization becomes a member as a result of the stock sale. If the acquired organization does not become a member of such a group, the *buying group* is the acquired organization.

Q–3: In the case of an asset sale, what are the selling group and the buying group?

A–3: In the case of an asset sale—

(a) The *selling group* is the controlled group of corporations or the group of trades or businesses under common control that includes the corporation or other trade or business that is selling the assets; and

(b) The *buying group* is the controlled group of corporations or the group of trades or businesses under common control that includes the corporation or other trade or business that is buying the assets.

Q–4: Who is an M&A qualified beneficiary?

A–4: (a) Asset sales: In the case of an asset sale, an individual is an M&A qualified beneficiary if the individual is a qualified beneficiary whose qualifying event occurred prior to or in connection with the sale and who is, or whose qualifying event occurred in connection with, a covered employee whose last employment prior to the qualifying event was associated with the assets being sold.

(b) Stock sales: In the case of a stock sale, an individual is an M&A qualified beneficiary if the individual is a qualified beneficiary whose qualifying event occurred prior to or in connection with the sale and who is, or whose qualifying event occurred in connection with, a covered employee whose last employment prior to the qualifying event was with the acquired organization.

(c) In the case of a qualified beneficiary who has experienced more than one qualifying event with respect to her or his current right to COBRA continuation coverage, the qualifying event referred to in paragraphs (a) and (b) of this Q&A–4 is the first qualifying event.

Q–5: In the case of a stock sale, is the sale a qualifying event with respect to a covered employee who is employed by the acquired organization before the sale and who continues to be employed by the acquired organization after the sale, or with respect to the spouse or dependent children of such a covered employee?

A–5: No. A covered employee who continues to be employed by the acquired organization after the sale does not experience a termination of employment as a result of the sale. Accordingly, the sale is not a qualifying event with respect to the covered employee, or with respect to the covered employee's spouse or dependent children, regardless of whether they are provided with group health coverage after the sale, and neither the covered employee, nor the covered employee's spouse or dependent children, become qualified beneficiaries as a result of the sale.

Q–6: In the case of an asset sale, is the sale a qualifying event with respect to a covered employee whose employment immediately before the sale was associated with the purchased assets, or with respect to the spouse or dependent children of such a covered employee who are covered under a group health plan of the selling group immediately before the sale?

A–6: (a) Yes, unless—

(1) The buying group is a successor employer under paragraph (c) of Q&A–

8 of this section or Q&A–2 of § 54.4980B–2, and the covered employee is employed by the buying group immediately after the sale; or

(2) The covered employee (or the spouse or any dependent child of the covered employee) does not lose coverage (within the meaning of paragraph (c) in Q&A–1 of § 54.4980B-4) under a group health plan of the selling group after the sale.

(b) Unless the conditions in paragraph (a)(1) or (2) of this Q&A–6 are satisfied, such a covered employee experiences a termination of employment with the selling group as a result of the asset sale, regardless of whether the covered employee is employed by the buying group or whether the covered employee's employment is associated with the purchased assets after the sale. Accordingly, the covered employee, and the spouse and dependent children of the covered employee who lose coverage under a plan of the selling group in connection with the sale, are M&A qualified beneficiaries in connection with the sale.

Q–7: In a business reorganization, are the buying group and the selling group permitted to allocate by contract the responsibility to make COBRA continuation coverage available to M&A qualified beneficiaries?

A–7: Yes. Nothing in this section prohibits a selling group and a buying group from allocating to one or the other of the parties in a purchase agreement the responsibility to provide the coverage required under §§ 54.4980B–1 through 54.4980B–10. However, if and to the extent that the party assigned this responsibility under the terms of the contract fails to perform, the party who has the obligation under Q&A–8 of this section to make COBRA continuation coverage available to M&A qualified beneficiaries continues to have that obligation.

Q–8: Which group health plan has the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries in a business reorganization?

A–8: (a) In the case of a business reorganization (whether a stock sale or an asset sale), so long as the selling group maintains a group health plan after the sale, a group health plan maintained by the selling group has the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to that sale. This Q&A–8 prescribes rules for cases in which the selling group ceases to provide any group health plan to any employee in connection with the sale. Paragraph (b) of this Q&A–8 contains these rules for stock sales, and paragraph (c) of this Q&A–8 contains these rules for asset sales. Neither a stock sale nor an asset sale has any effect on the COBRA continuation coverage requirements applicable to any group health plan for any period before the sale.

(b)(1) In the case of a stock sale, if the selling group ceases to provide any group health plan to any employee in connection with the sale, a group health plan maintained by the buying group has the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to that stock sale. A group health plan of the buying group has this obligation beginning on the later of the following two dates and continuing as long as the buying group continues to maintain a group health plan (but subject to the rules in § 54.4980B–7, relating to the duration of COBRA continuation coverage)—

(i) The date the selling group ceases to provide any group health plan to any employee; or

(ii) The date of the stock sale.

(2) The determination of whether the selling group's cessation of providing any group health plan to any employee is in connection with the stock sale is based on all of the relevant facts and circumstances. A group health plan of the buying group does not, as a result of the stock sale, have an obligation to make COBRA continuation coverage available to those qualified beneficiaries of the selling group who are not M&A qualified beneficiaries with respect to that sale.

(c)(1) In the case of an asset sale, if the selling group ceases to provide any group health plan to any employee in connection with the sale and if the buying group continues the business operations associated with the assets

purchased from the selling group without interruption or substantial change, then the buying group is a successor employer to the selling group in connection with that asset sale. A buying group does not fail to be a successor employer in connection with an asset sale merely because the asset sale takes place in connection with a proceeding in bankruptcy under Title 11 of the United States Code. If the buying group is a successor employer, a group health plan maintained by the buying group has the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to that asset sale. A group health plan of the buying group has this obligation beginning on the later of the following two dates and continuing as long as the buying group continues to maintain a group health plan (but subject to the rules in § 54.4980B–7, relating to the duration of COBRA continuation coverage)—

(i) The date the selling group ceases to provide any group health plan to any employee; or

(ii) The date of the asset sale.

(2) The determination of whether the selling group's cessation of providing any group health plan to any employee is in connection with the asset sale is based on all of the relevant facts and circumstances. A group health plan of the buying group does not, as a result of the asset sale, have an obligation to make COBRA continuation coverage available to those qualified beneficiaries of the selling group who are not M&A qualified beneficiaries with respect to that sale.

(d) The rules of Q&A–1 through Q&A–7 of this section and this Q&A–8 are illustrated by the following examples; in each example, each group health plan is subject to COBRA:

Stock Sale Examples

Example 1. (i) Selling Group *S* consists of three corporations, *A*, *B*, and *C*. Buying Group *P* consists of two corporations, *D* and *E*. *P* enters into a contract to purchase all the stock of *C* from *S* effective July 1, 2002. Before the sale of *C*, *S* maintains a single group health plan for the employees of *A*, *B*, and *C* (and their families). *P* maintains a single group health plan for the employees of *D* and *E* (and their families). Effective July 1, 2002, the employees of *C* (and their families) become covered under *P*'s plan. On June 30, 2002, there are 48 qualified beneficiaries receiving COBRA continuation coverage under *S*'s plan, 15 of whom are M&A qualified beneficiaries with respect to the sale of *C*. (The other 33 qualified beneficiaries had qualifying events in connection with a covered employee whose last employment before the qualifying event was with either *A* or *B*.)

(ii) Under these facts, *S*'s plan continues to have the obligation to make COBRA continuation coverage available to the 15 M&A qualified beneficiaries under *S*'s plan after the sale of *C* to *P*. The employees who continue in employment with *C* do not experience a qualifying event by virtue of *P*'s acquisition of *C*. If they experience a qualifying event after the sale, then the group health plan of *P* has the obligation to make COBRA continuation coverage available to them.

Example 2. (i) Selling Group *S* consists of three corporations, *A*, *B*, and *C*. Each of *A*, *B*, and *C* maintains a group health plan for its employees (and their families). Buying Group *P* consists of two corporations, *D* and *E*. *P* enters into a contract to purchase all of the stock of *C* from *S* effective July 1, 2002. As of June 30, 2002, there are 14 qualified beneficiaries receiving COBRA continuation coverage under *C*'s plan. *C* continues to employ all of its employees and continues to maintain its group health plan after being acquired by *P* on July 1, 2002.

(ii) Under these facts, *C* is an acquired organization and the 14 qualified beneficiaries under *C*'s plan are M&A qualified beneficiaries. A group health plan of *S* (that is, either the plan maintained by *A* or the plan maintained by *B*) has the obligation to make COBRA continuation coverage available to the 14 M&A qualified beneficiaries. *S* and *P* could negotiate to have *C*'s plan continue to make COBRA continuation coverage available to the 14 M&A qualified beneficiaries. In such a case, neither *A*'s plan nor *B*'s plan would make COBRA continuation coverage available to the 14 M&A qualified beneficiaries unless *C*'s plan failed to fulfill its contractual responsibility to make COBRA continuation coverage available to the M&A qualified beneficiaries. *C*'s employees (and their spouses and dependent children) do not experience a qualifying event in connection with *P*'s acquisition of *C*, and consequently no plan maintained by either *P* or *S* has any obligation to make COBRA continuation coverage available to *C*'s employees (or their spouses or dependent children) in connection with the transfer of stock in *C* from *S* to *P*.

Example 3. (i) The facts are the same as in *Example 2*, except that *C* ceases to employ two employees on June 30, 2002, and those two employees never become covered under *P*'s plan.

(ii) Under these facts, the two employees experience a qualifying event on June 30,

2002 because their termination of employment causes a loss of group health coverage. A group health plan of *S* (that is, either the plan maintained by *A* or the plan maintained by *B*) has the obligation to make COBRA continuation coverage available to the two employees (and to any spouse or dependent child of the two employees who loses coverage under *C*'s plan in connection with the termination of employment of the two employees) because they are M&A qualified beneficiaries with respect to the sale of *C*.

Example 4. (i) Selling Group *S* consists of three corporations, *A*, *B*, and *C*. Buying Group *P* consists of two corporations, *D* and *E*. *P* enters into a contract to purchase all of the stock of *C* from *S* effective July 1, 2002. Before the sale of *C*, *S* maintains a single group health plan for the employees of *A*, *B*, and *C* (and their families). *P* maintains a single group health plan for the employees of *D* and *E* (and their families). Effective July 1, 2002, the employees of *C* (and their families) become covered under *P*'s plan. On June 30, 2002, there are 25 qualified beneficiaries receiving COBRA continuation coverage under *S*'s plan, 20 of whom are M&A qualified beneficiaries with respect to the sale of *C*. (The other five qualified beneficiaries had qualifying events in connection with a covered employee whose last employment before the qualifying event was with either *A* or *B*.) S terminates its group health plan effective June 30, 2002 and begins to liquidate the assets of *A* and *B* and to lay off the employees of *A* and *B*.

(ii) Under these facts, *S* ceases to provide a group health plan to any employee in connection with the sale of *C* to *P*. Thus, beginning July 1, 2002 *P*'s plan has the obligation to make COBRA continuation coverage available to the 20 M&A qualified beneficiaries, but *P* is not obligated to make COBRA continuation coverage available to the other 5 qualified beneficiaries with respect to *S*'s plan as of June 30, 2002 or to any of the employees of *A* or *B* whose employment is terminated by *S* (or to any of those employees' spouses or dependent children).

Asset Sale Examples

Example 5. (i) Selling Group *S* provides group health plan coverage to employees at each of its operating divisions. *S* sells the assets of one of its divisions to Buying Group *P*. Under the terms of the group health plan covering the employees at the division being sold, their coverage will end on the date of the sale. *P* hires all but one of those employees, gives them the same positions that they had with *S* before the sale, and provides them with coverage under a group health plan. Immediately before the sale, there are two qualified beneficiaries receiving COBRA continuation coverage under a group health plan of *S* whose qualifying events occurred in connection with a covered employee whose last employment prior to the qualifying event was associated with the assets sold to *P*.

(ii) These two qualified beneficiaries are M&A qualified beneficiaries with respect to the asset sale to *P*. Under these facts, a group health plan of *S* retains the obligation to make COBRA continuation coverage available to these two M&A qualified beneficiaries. In addition, the one employee *P* does not hire as well as all of the employees *P* hires (and the spouses and dependent children of these employees) who were covered under a group health plan of *S* on the day before the sale are M&A qualified beneficiaries with respect to the sale. A group health plan of *S* also has the obligation to make COBRA continuation coverage available to these M&A qualified beneficiaries.

Example 6. (i) Selling Group *S* provides group health plan coverage to employees at each of its operating divisions. *S* sells substantially all of the assets of all of its divisions to Buying Group *P*, and *S* ceases to provide any group health plan to any employee on the date of the sale. *P* hires all but one of *S*'s employees on the date of the asset sale by *S*, gives those employees the same positions that they had with *S* before the sale, and continues the business operations of those divisions without substantial change or interruption. *P* provides these employees with coverage under a group health plan. Immediately before the sale, there are 10 qualified beneficiaries receiving COBRA continuation coverage under a group health plan of *S* whose qualifying events occurred in connection with a covered employee whose last employment prior to the qualifying event was associated with the assets sold to *P*.

(ii) These 10 qualified beneficiaries are M&A qualified beneficiaries with respect to the asset sale to *P*. Under these facts, *P* is a successor employer described in paragraph (c) of this Q&A–8. Thus, a group health plan of *P* has the obligation to make COBRA continuation coverage available to these 10 M&A qualified beneficiaries.

(iii) The one employee that *P* does not hire and the family members of that employee are also M&A qualified beneficiaries with respect to the sale. A group health plan of *P* also has the obligation to make COBRA continuation coverage available to these M&A qualified beneficiaries.

(iv) The employees who continue in employment in connection with the asset sale (and their family members) and who were covered under a group health plan of *S* on the day before the sale are not M&A qualified beneficiaries because *P* is a successor employer to *S* in connection with the asset sale. Thus, no group health plan of *P* has any obligation to make COBRA continuation coverage available to these continuing employees with respect to the qualifying event that

resulted from their losing coverage under *S*'s plan in connection with the asset sale.

Example 7. (i) Selling Group *S* provides group health plan coverage to employees at each of its two operating divisions. *S* sells the assets of one of its divisions to Buying Group *P1*. Under the terms of the group health plan covering the employees at the division being sold, their coverage will end on the date of the sale. *P1* hires all but one of those employees, gives them the same positions that they had with *S* before the sale, and provides them with coverage under a group health plan.

(ii) Under these facts, a group health plan of *S* has the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to the sale to *P1*. (If an M&A qualified beneficiary first became covered under *P1*'s plan after electing COBRA continuation coverage under *S*'s plan, then *S*'s plan could terminate the COBRA continuation coverage once the M&A qualified beneficiary became covered under *P1*'s plan, provided that the remaining conditions of Q&A–2 of § 54.4980B–7 were satisfied.)

(iii) Several months after the sale to *P1*, *S* sells the assets of its remaining division to Buying Group *P2*, and *S* ceases to provide any group health plan to any employee on the date of that sale. Thus, under Q&A–1 of § 54.4980B–7, *S* ceases to have an obligation to make COBRA continuation coverage available to any qualified beneficiary on the date of the sale to *P2*. *P1* and *P2* are unrelated organizations.

(iv) Even if it was foreseeable that *S* would sell its remaining division to an unrelated third party after the sale to *P1*, under these facts the cessation of *S* to provide any group health plan to any employee on the date of the sale to *P2* is not in connection with the asset sale to *P1*. Thus, even after the date *S* ceases to provide any group health plan to any employee, no group health plan of *P1* has any obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to the asset sale to *P1* by *S*. If *P2* is a successor employer under the rules of paragraph (c) of this Q&A–8 and maintains one or more group health plans after the sale, then a group health plan of *P2* would have an obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to the asset sale to *P2* by *S* (but in such a case employees of *S* before the sale who continued working for *P2* after the sale would not be M&A qualified beneficiaries). However, even in such a case, no group health plan of *P2* would have an obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to the asset sale to *P1* by *S*. Thus, under these facts, after *S* has ceased to provide any group health plan to any employee, no plan has an obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to the asset sale to *P1*.

Example 8. (i) Selling Group *S* provides group health plan coverage to employees at each of its operating divisions. *S* sells substantially all of the assets of all of its divisions to Buying Group *P*. *P* hires most of *S*'s employees on the date of the purchase of *S*'s assets, retains those employees in the same positions that they had with *S* before the purchase, and continues the business operations of those divisions without substantial change or interruption. *P* provides these employees with coverage under a group health plan. *S* continues to employ a few employees for the principal purpose of winding up the affairs of *S* in preparation for liquidation. *S* continues to provide coverage under a group health plan to these few remaining employees for several weeks after the date of the sale and then ceases to provide any group health plan to any employee.

(ii) Under these facts, the cessation by *S* to provide any group health plan to any employee is in connection with the asset sale to *P*. Because of this, and because *P* continued the business operations associated with those assets without substantial change or interruption, *P* is a successor employer to *S* with respect to the asset sale. Thus, a group health plan of *P* has the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries with respect to the sale beginning on the date that *S* ceases to provide any group health plan to any employee. (A group health plan of *S* retains this obligation for the several weeks after the date of the sale until *S* ceases to provide any group health plan to any employee.)

Q–9: Can the cessation of contributions by an employer to a multiemployer group health plan be a qualifying event?

A–9: The cessation of contributions by an employer to a multiemployer group health plan is not itself a qualifying event, even though the cessation of contributions may cause current employees (and their spouses and dependent children) to lose coverage under the multiemployer plan. An event coinciding with the employer's cessation of contributions (such as a reduction of hours of employment in the case of striking employees) will constitute a qualifying event if it otherwise satisfies the requirements of Q&A–1 of § 54.4980B–4.

Q–10: If an employer stops contributing to a multiemployer group health plan, does the multiemployer plan have

the obligation to make COBRA continuation coverage available to a qualified beneficiary who was receiving coverage under the multiemployer plan on the day before the cessation of contributions and who is, or whose qualifying event occurred in connection with, a covered employee whose last employment prior to the qualifying event was with the employer that has stopped contributing to the multiemployer plan?

A–10: (a) In general, yes. (See Q&A–3 of § 54.4980B–2 for a definition of *multiemployer plan*.) If, however, the employer that stops contributing to the multiemployer plan makes group health plan coverage available to (or starts contributing to another multiemployer plan that is a group health plan with respect to) a class of the employer's employees formerly covered under the multiemployer plan, the plan maintained by the employer (or the other multiemployer plan), from that date forward, has the obligation to make COBRA continuation coverage available to any qualified beneficiary who was receiving coverage under the multiemployer plan on the day before the cessation of contributions and who is, or whose qualifying event occurred in connection with, a covered employee whose last employment prior to the qualifying event was with the employer.

(b) The rules of Q&A–9 of this section and this Q&A–10 are illustrated by the following examples; in each example, each group health plan is subject to COBRA:

Example 1. (i) Employer *Z* employs a class of employees covered by a collective bargaining agreement and participating in multiemployer group health plan *M*. As required by the collective bargaining agreement, *Z* has been making contributions to *M*. *Z* experiences financial difficulties and stops making contributions to *M* but continues to employ all of the employees covered by the collective bargaining agreement. *Z*'s cessation of contributions to *M* causes those employees (and their spouses and dependent children) to lose coverage under *M*. *Z* does not make group health plan coverage available to any of the employees covered by the collective bargaining agreement.

(ii) After *Z* stops contributing to *M*, *M* continues to have the obligation to make COBRA continuation coverage available to any qualified beneficiary who experienced a qualifying event that preceded or coincided with the cessation of contributions to *M* and whose coverage under *M* on the day before the qualifying event was due to an employment affiliation with *Z*. The loss of coverage under *M* for those employees of *Z* who continue in employment (and the loss of coverage for their spouses and dependent children) does not constitute a qualifying event.

Example 2. (i) The facts are the same as in *Example 1* except that *B*, one of the employees covered under *M* before *Z* stops contributing to *M*, is transferred into management. *Z* maintains a group health plan for managers and *B* becomes eligible for coverage under the plan on the day of *B*'s transfer.

(ii) Under these facts, *Z* does not make group health plan coverage available to a class of employees formerly covered under *M* after *B* becomes eligible under *Z*'s group health plan for managers. Accordingly, *M* continues to have the obligation to make COBRA continuation coverage available to any qualified beneficiary who experienced a qualifying event that preceded or coincided with the cessation of contributions to *M* and whose coverage under *M* on the day before the qualifying event was due to an employment affiliation with *Z*.

Example 3. (i) Employer *Y* employs two classes of employees—skilled and unskilled laborers—covered by a collective bargaining agreement and participating in multiemployer group health plan *M*. As required by the collective bargaining agreement, *Y* has been making contributions to *M*. *Y* stops making contributions to *M* but continues to employ all the employees covered by the collective bargaining agreement. *Y*'s cessation of contributions to *M* causes those employees (and their spouses and dependent children) to lose coverage under *M*. *Y* makes group health plan coverage available to the skilled laborers immediately after their coverage ceases under *M*, but *Y* does not make group health plan coverage available to any of the unskilled laborers.

(ii) Under these facts, because *Y* makes group health plan coverage available to a class of employees previously covered under *M* immediately after both classes of employees lose coverage under *M*, *Y* alone has the obligation to make COBRA continuation coverage available to any qualified beneficiary who experienced a qualifying event that preceded or coincided with the cessation of contributions to *M* and whose coverage under *M* on the day before the qualifying event was due to an employment affiliation with *Y*, regardless of whether the employment affiliation was as a skilled or unskilled laborer. However, the loss of coverage under *M* for those employees of *Y* who continue in employment (and the loss of coverage for their spouses and dependent children) does not constitute a qualifying event.

Example 4. (i) Employer *X* employs a class of employees covered by a collective bargaining agreement and participating in multiemployer group health plan *M*. As required by the collective bargaining agreement, *X* has been making contributions to *M*. *X* experiences financial difficulties and is forced into bankruptcy by its creditors. *X* continues to employ all of the employees covered by the collective bargaining agreement. *X* also continues to make contributions to *M* until the current collective bargaining agreement expires, on June 30, 2001, and then *X* stops making contributions to *M*. *X*'s employees (and their spouses and dependent children) lose coverage under *M* effective July 1, 2001. *X* does not enter into another collective bargaining agreement covering the class of employees covered by the expired collective bargaining agreement. Effective September 1, 2001, *X* establishes a group health plan covering the class of employees formerly covered by the collective bargaining agreement. The group health plan also covers their spouses and dependent children.

(ii) Under these facts, *M* has the obligation to make COBRA continuation coverage available from July 1, 2001 until August 31, 2001, and the group health plan established by *X* has the obligation to make COBRA continuation coverage available from September 1, 2001 until the obligation ends (see Q&A–1 of § 54.4980B–7) to any qualified beneficiary who experienced a qualifying event that preceded or coincided with the cessation of contributions to *M* and whose coverage under *M* on the day before the qualifying event was due to an employment affiliation with *X*. The loss of coverage under *M* for those employees of *X* who continue in employment (and the loss of coverage for their spouses and dependent children) does not constitute a qualifying event.

Example 5. (i) Employer *W* employs a class of employees covered by a collective bargaining agreement and participating in multiemployer group health plan *M*. As required by the collective bargaining agreement, *W* has been making contributions to *M*. The employees covered by the collective bargaining agreement vote to decertify their current employee representative effective January 1, 2002 and vote to certify a new employee representative effective the same date. As a consequence, on January 1, 2002 they cease to be covered under *M* and commence to be covered under multiemployer group health plan *N*.

(ii) Effective January 1, 2002, *N* has the obligation to make COBRA continuation coverage available to any qualified beneficiary who experienced a qualifying event that preceded or coincided with the cessation of contributions to *M* and whose coverage under *M* on the day before the qualifying event was due to an employment affiliation with W. The loss of coverage under *M* for those employees of W who continue in employment (and the loss of coverage for their spouses and dependent children) does not constitute a qualifying event.

[T.D. 8928, 66 FR 1855, Jan. 10, 2001]

§ 54.4980B–10 Interaction of FMLA and COBRA.

The following questions-and-answers address how the taking of leave under the Family and Medical Leave Act of 1993 (FMLA) (29 U.S.C. 2601–2619) affects the COBRA continuation coverage requirements:

Q–1: In what circumstances does a qualifying event occur if an employee does not return from leave taken under FMLA?

A–1: (a) The taking of leave under FMLA does not constitute a qualifying event. A qualifying event under Q&A–1 of § 54.4980B–4 occurs, however, if—

(1) An employee (or the spouse or a dependent child of the employee) is covered on the day before the first day of FMLA leave (or becomes covered during the FMLA leave) under a group health plan of the employee's employer;

(2) The employee does not return to employment with the employer at the end of the FMLA leave; and

(3) The employee (or the spouse or a dependent child of the employee) would, in the absence of COBRA continuation coverage, lose coverage under the group health plan before the end of the maximum coverage period.

(b) However, the satisfaction of the three conditions in paragraph (a) of this Q&A–1 does not constitute a qualifying event if the employer eliminates, on or before the last day of the employee's FMLA leave, coverage under a group health plan for the class of employees (while continuing to employ that class of employees) to which the employee would have belonged if the employee had not taken FMLA leave.

Q–2: If a qualifying event described in Q&A–1 of this section occurs, when does it occur, and how is the maximum coverage period measured?

A–2: A qualifying event described in Q&A–1 of this section occurs on the last day of FMLA leave. (The determination of when FMLA leave ends is

not made under the rules of this section. See the FMLA regulations, 29 CFR Part 825 (§§ 825.100–825.800).) The maximum coverage period (see Q&A–4 of § 54.4980B–7) is measured from the date of the qualifying event (that is, the last day of FMLA leave). If, however, coverage under the group health plan is lost at a later date and the plan provides for the extension of the required periods (see paragraph (b) of Q&A–4 of § 54.4980B–7), then the maximum coverage period is measured from the date when coverage is lost. The rules of this Q&A–2 are illustrated by the following examples:

Example 1. (i) Employee *B* is covered under the group health plan of Employer *X* on January 31, 2001. *B* takes FMLA leave beginning February 1, 2001. *B*'s last day of FMLA leave is 12 weeks later, on April 25, 2001, and *B* does not return to work with *X* at the end of the FMLA leave. If *B* does not elect COBRA continuation coverage, *B* will not be covered under the group health plan of *X* as of April 26, 2001.

(ii) *B* experiences a qualifying event on April 25, 2001, and the maximum coverage period is measured from that date. (This is the case even if, for part or all of the FMLA leave, *B* fails to pay the employee portion of premiums for coverage under the group health plan of *X* and is not covered under *X*'s plan. See Q&A–3 of this section.)

Example 2. (i) Employee *C* and *C*'s spouse are covered under the group health plan of Employer *Y* on August 15, 2001. *C* takes FMLA leave beginning August 16, 2001. *C* informs *Y* less than 12 weeks later, on September 28, 2001, that *C* will not be returning to work. Under the FMLA regulations, 29 CFR Part 825 (§§ 825.100–825.800), *C*'s last day of FMLA leave is September 28, 2001. *C* does not return to work with *Y* at the end of the FMLA leave. If *C* and *C*'s spouse do not elect COBRA continuation coverage, they will not be covered under the group health plan of *Y* as of September 29, 2001.

(ii) *C* and *C*'s spouse experience a qualifying event on September 28, 2001, and the maximum coverage period (generally 18 months) is measured from that date. (This is the case even if, for part or all of the FMLA leave, *C* fails to pay the employee portion of premiums for coverage under the group health plan of *Y* and *C* or *C*'s spouse is not covered under *Y*'s plan. See Q&A–3 of this section.)

Q–3: If an employee fails to pay the employee portion of premiums for coverage under a group health plan during FMLA leave or declines coverage under a group health plan during FMLA leave, does this affect the determination of whether or when the employee has experienced a qualifying event?

A–3: No. Any lapse of coverage under a group health plan during FMLA leave is irrelevant in determining whether a set of circumstances constitutes a qualifying event under Q&A–1 of this section or when such a qualifying event occurs under Q&A–2 of this section.

Q–4: Is the application of the rules in Q&A–1 through Q&A–3 of this section affected by a requirement of state or local law to provide a period of coverage longer than that required under FMLA?

A–4: No. Any state or local law that requires coverage under a group health plan to be maintained during a leave of absence for a period longer than that required under FMLA (for example, for 16 weeks of leave rather than for the 12 weeks required under FMLA) is disregarded for purposes of determining when a qualifying event occurs under Q&A–1 through Q&A–3 of this section.

Q–5: May COBRA continuation coverage be conditioned upon reimbursement of the premiums paid by the employer for coverage under a group health plan during FMLA leave?

A–5: No. The U.S. Department of Labor has published rules describing the circumstances in which an employer may recover premiums it pays to maintain coverage, including family coverage, under a group health plan during FMLA leave from an employee who fails to return from leave. See 29 CFR 825.213. Even if recovery of premiums is permitted under 29 CFR 825.213, the right to COBRA continuation coverage cannot be conditioned upon the employee's reimbursement of the employer for premiums the employer paid to maintain coverage under a group health plan during FMLA leave.

[T.D. 8928, 66 FR 1855, Jan. 10, 2001]

§ 54.4980D–1 Requirement of return and time for filing of the excise tax under section 4980D.

Q–1: If a person is liable for the excise tax under section 4980D, what form must the person file and what is the due date for the filing and payment of the excise tax?

A–1: (a) *In general. See* §§ 54.6011–2 and 54.6151–1.

(b) *Due date for filing of return by employers. See* § 54.6071–1(b)(1).

(c) *Due date for filing of return by multiemployer plans or multiple employer health plans. See* § 54.6071–1(b)(2).

(d) *Effective/applicability date.* In the case of an employer or other person mentioned in paragraph (b) of this Q & A–1, the rules in this Q & A–1 are effective for taxable years beginning on or after January 1, 2010. In the case of a plan mentioned in paragraph (c) of this Q & A–1, the rules in this Q & A–1 are effective for plan years beginning on or after January 1, 2010.

[T.D. 9457, 74 FR 45997, Sept. 8, 2009]

§ 54.4980E–1 Requirement of return and time for filing of the excise tax under section 4980E.

Q–1: If a person is liable for the excise tax under section 4980E, what form must the person file and what is the due date for the filing and payment of the excise tax?

A–1: (a) *In general. See* §§ 54.6011–2, 54.6151–1 and 54.6071–1(c).

(b) *Effective/applicability date.* The rules in this Q & A–1 are effective for plan years beginning on or after January 1, 2010.

[T.D. 9457, 74 FR 45997, Sept. 8, 2009]

§ 54.4980F–1 Notice requirements for certain pension plan amendments significantly reducing the rate of future benefit accrual.

The following questions and answers concern the notification requirements imposed by 4980F of the Internal Revenue Code and section 204(h) of ERISA relating to a plan amendment of an applicable pension plan that significantly reduces the rate of future benefit accrual or that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy.

LIST OF QUESTIONS

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 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 a reduction in an early retirement benefit or retirement-type subsidy is significant for purposes of section 4980F and 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 are the effective dates of section 4980F, section 204(h), as amended by EGTRRA, and these regulations?

QUESTIONS AND ANSWERS

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 and alternate payees who are applicable individuals (as defined in Q&A–10 of this section), to certain employee organizations, and to contributing employers under a multiemployer plan (as described in Q&A–10(a) of this section). 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. The notice requirements of section 4980F generally are parallel to the notice requirements of section 204(h), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (2001) (EGTRRA). However, the consequences of the failure to satisfy the requirements 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 an egregious failure to satisfy the notice requirements. 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 and contracts under section 403(b) of the Internal Revenue Code, 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. (a) *Section 204(h) notice* is notice that complies with section 4980F(e) of the Internal Revenue Code, section 204(h)(1) of ERISA, and this section.

(b) 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.

(b) *Early retirement benefits and retirement-type subsidies.* Section 204(h) notice is also 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 that the amendment will reduce the amount of the future annual benefit commencing at normal retirement age (or at actual retirement age, if later) 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 that the amendment will reduce the amount of contributions or forfeitures allocated for any future 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 that the amendment will 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*—(1) *In general.* 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.

(2) *Provisions incorporated by reference in plan.* If all or a part of a plan's rate of future benefit accrual, or an early retirement benefit or retirement-type subsidy provided under the plan, depends on provisions in another document that are referenced in the plan document, a change in the provisions of the other document is an amendment of the plan.

(b) *Plan provisions not taken into account*—(1) *In general.* 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.

(2) *Interaction with section 411(d)(6).* Any benefit that is not a section 411(d)(6) protected benefit as described in §§1.411(d)–3(g)(14) and 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)–3(c), (d), or (f), or under §1.411(d)–4, Q&A–2(a)(2), (a)(3), (b)(1), or (b)(2)(ii) through (b)(2)(xi) 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 the right to make after-tax deferrals are not taken into account.

(c) *Examples.* The following examples illustrate the rules in this Q&A–7:

Example 1. (i) *Facts.* A defined benefit plan provides a normal retirement benefit equal to 50% of highest 5-year average pay multiplied by 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.

Example 2. (i) *Facts.* Plan C is a multiemployer defined benefit plan subject to several collective bargaining agreements. The specific benefit formula under Plan C that applies to an employee depends on the hourly rate of contribution of the employee's employer, which is set forth in the provisions of the collective bargaining agreements that are referenced in the Plan C document. Collective Bargaining Agreement A between Employer B and the union representing employees of Employer B is renegotiated to provide that the hourly contribution rate for an employee of B who is subject to the Collective Bargaining Agreement A will decrease. That decrease will result in a decrease in the rate of future benefit accrual for employees of B.

(ii) *Conclusion.* Under paragraph (a)(2) of this Q&A–7, the change to Collective Bargaining Agreement A is a plan amendment that is a section 204(h) amendment if the reduction in the rate of future benefit accrual is significant.

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 4980F and section 204(h)?

A–8. (a) *General rule.* Whether an amendment reducing the rate of future benefit accrual or eliminating or reducing an early retirement benefit or retirement-type subsidy provides for a reduction that is significant for purposes of section 4980F (and section 204(h) of ERISA) is determined based on reasonable expectations taking into account the relevant facts and circumstances at the time the amendment is adopted, or, if earlier, at the effective date of the amendment.

(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 (or at actual retirement age, if later), 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 (or at actual retirement age, if later), 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. An amendment to convert a money purchase pension plan to a profit-sharing or other individual account plan that is not subject to section 412 of the Internal Revenue Code is, in all cases, deemed to be an amendment that provides for a significant reduction in the rate of future benefit accrual.

(c) *Application to certain amendments reducing early retirement benefits or retirement-type subsidies.* 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 paragraphs (c), (d), and (f) of § 1.411(d)–3 of this chapter (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). However, in determining whether an amendment reducing a retirement-type subsidy constitutes a significant reduction because it reduces a retirement-type subsidy as permitted under § 1.411(d)–3(e)(6) of this chapter, the amendment is treated in the same manner as an amendment that limits the retirement-type subsidy to benefits that accrue before the applicable amendment date (as defined at § 1.411(d)–3(g)(4) of this chapter) with respect to each participant or alternate payee to whom the reduction is reasonably expected to apply.

(d) *Plan amendments reflecting a change in statutorily mandated minimum present value rules.* If a defined benefit plan offers a distribution to which the minimum present value rules of section 417(e)(3) apply (other than a payment to which section 411(a)(13)(A) applies) and the plan is amended to reflect the changes to the applicable interest rate and applicable mortality table in section 417(e)(3) made by the Pension Protection Act of 2006, Public Law 109–780 (120 Stat. 780) (PPA '06) (and no change is made in the dates on which the payment will be made), no section 204(h) notice is required to be provided.

(e) *Examples.* The following examples illustrate the rules in this Q&A–8:

Example 1. (i) *Facts.* Pension Plan A is a defined benefit plan that provides a rate of benefit accrual of 1% of highest-5 years pay multiplied by years of service, payable annually for life commencing at normal retirement age (or at actual retirement age, if later). An amendment to Plan A is adopted on August 1, 2009, effective January 1, 2010, to provide that any participant who separates from service after December 31, 2009, and before January 1, 2015, will have the same number of years of service he or she would have had

if his or her service continued to December 31, 2014.

(ii) *Conclusion*. In this example, the effective date of the plan amendment is January 1, 2010. While the amendment will result in a reduction in the annual rate of future benefit accrual from 2011 through 2014 (because, under the amendment, benefits based upon an additional 5 years of service accrue on January 1, 2010, and no additional service is credited after January 1, 2010 until January 1, 2015), the amendment does not result in a reduction that is significant because the amount of the annual benefit commencing at normal retirement age (or at actual retirement age, if later) under the terms of the plan as amended is not under any conditions less than the amount of the annual benefit commencing at normal retirement age (or at actual retirement age, if later) to which any participant would have been entitled under the terms of the plan had the amendment not been made.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that the 2009 amendment does not alter the plan provisions relating to a participant's number of years of service, but instead amends the plan's provisions relating to early retirement benefits. Before the amendment, the plan provides for distributions before normal retirement age to be actuarially reduced, but, if a participant retires after attainment of age 55 and completion of 10 years of service, the applicable early retirement reduction factor is 3% per year for the years between the ages 65 and 62 and 6% per year for the ages from 62 to 55. The amendment changes these provisions so that an actuarial reduction applies in all cases, but, in accordance with section 411(d)(6)(B), provides that no participant's early retirement benefit will be less than the amount provided under the plan as in effect on December 31, 2009 with respect to service before January 1, 2010. For participant X, the reduction is significant.

(ii) *Conclusion*. The amendment will result in a reduction in a retirement-type subsidy provided under Plan A (*i.e.*, Plan A's early retirement subsidy). Section 204(h) notice must be provided to participant X and any other participant for whom the reduction is significant and the notice must be provided at least 45 days before January 1, 2010 (or by such other date as may apply under Q&A–9 of this section).

Example 3. (i) *Facts*. The facts are the same as in *Example 2*, except that, for participant X, the change does not go into effect for any annuity commencement date before January 1, 2011. Participant X continues employment through January 1, 2011.

(ii) *Conclusion*. The conclusion is the same as in *Example 2*. Taking into account the rule in the second sentence of Q&A–8(c) of this section, the reduction that occurs for participant X on January 1, 2011, is treated as the same reduction that occurs under *Example 2*. Accordingly, assuming that the reduction is significant, section 204(h) notice must be provided to participant X at least 45 days before the January 1, 2010 effective date of the amendment (or by such other date as may apply under Q&A–9 of this section).

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

A–9. (a) *45-day general rule*. Except as otherwise provided in 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 (e) 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 paragraphs (d)(2) and (g) of this Q&A–9, section 204(h) notice must be provided at least 15 days before the effective date of any section 204(h) amendment in the case of a small plan. 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) *15-day rule for multiemployer plans*. Except for amendments described in paragraphs (d)(2) and (g) of this Q&A–9, section 204(h) notice must be provided at least 15 days before the effective date of any section 204(h) amendment in the case of a multiemployer plan. For purposes of this section, a multiemployer plan means a multiemployer plan as defined in section 414(f) of the Internal Revenue Code.

(d) *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 paragraphs (d)(2) and (g) 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 a 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 (d), see §1.410(b)–2(f) of this chapter for the definition of acquisition or disposition.

(e) *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 (d) 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.

(f) *Special timing rule for certain plans maintained by commercial airlines*. *See* section 402 of PPA '06 for a special rule that applies to certain plans maintained by an employer that is a commercial passenger airline or the principal business of which is providing catering services to a commercial passenger airline. Under this special rule, section 204(h) notice must be provided at least 15 days before the effective date of the amendment.

(g) *Special timing rules relating to certain section 204(h) amendments that reduce section 411(d)(6) protected benefits*—(1) *Plan amendments permitted to reduce prior accruals*. This paragraph (g) generally provides special rules with respect to a plan amendment that would not violate section 411(d)(6) even if the amendment were to reduce section 411(d)(6) protected benefits, which are limited to accrued benefits that are attributable to service before the applicable amendment date. For example, this paragraph (g) applies to amendments that are permitted to be effective retroactively under section 412(d)(2) of the Code (section 412(c)(8) for plan years beginning before January 1, 2008), section 418D of the Code, section 418E of the Code, section 4281 of ERISA, or section 1107 of PPA '06. *See*, generally, §1.411(d)–3(a)(1).

(2) *General timing rule for amendments to which this paragraph (g) applies*. For an amendment to which this paragraph (g) applies, the amendment is effective on the first date on which the plan is operated as if the amendment were in effect. Thus, except as otherwise provided in this paragraph (g), a section 204(h) notice for an amendment to which paragraph (a) of this section applies that is adopted after the effective date of the amendment must be provided, with respect to any applicable individual, at least 45 days before (or such other date as may apply under paragraph (b), (c), (d), or (f) of this Q&A–9) the date the amendment is put into operational effect.

(3) *Special rules for section 204(h) notices provided in connection with other disclosure requirements*—(i) *In general*. Notwithstanding the requirements in this Q&A–9 and Q&A–11 of this section, if a plan provides one of the notices in paragraph (g)(3)(ii) of this Q&A–9, in accordance with the applicable timing and content rules for such notice, the plan is treated as timely providing a section 204(h) notice with respect to a section 204(h) amendment.

(ii) *Notice requirements*. The notices in this paragraph (g)(3)(ii) are—

(A) A notice required under any revenue ruling, notice, or other guidance published under the authority of the Commissioner in the Internal Revenue Bulletin to affected parties in connection with a retroactive plan amendment described in section 412(d)(2) (section 412(c)(8) for plan years beginning before January 1, 2008);

(B) A notice required under section 101(j) of ERISA if an amendment is adopted to comply with the benefit limitation requirements of section 206(g) of ERISA (section 436 of the Code);

(C) A notice required under section 432(b)(3)(D) of the Code for an amendment adopted to comply with the benefit restrictions under section 432(f)(2);

(D) A notice required under section 418D, or section 4244A(b) of ERISA, for an amendment that reduces or eliminates accrued benefits attributable to employer contributions with respect to a multiemployer plan in reorganization;

(E) A notice required under section 418E, or section 4245(e) of ERISA, relating to the effects of the insolvency status for a multiemployer plan; and

(F) A notice required under section 4281 of ERISA for an amendment of a multiemployer plan reducing benefits pursuant to section 4281(c) of ERISA.

(4) *Delegation of authority to Commissioner*. The Commissioner may provide special rules under section 4980F, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii)(*b*) of this chapter), that the Commissioner determines to be necessary or appropriate with respect to a section 204(h) amendment—

(A) That applies to benefits accrued before the applicable amendment date but that does not violate section 411(d)(6); or

(B) For which there is a required notice relating to a reduction in benefits and such notice has timing and content requirements similar to a section 204(h) notice with respect to a significant reduction in the rate of future benefit accruals.

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, to each employee organization representing participants who are applicable individuals, and, for plan years beginning after December 31, 2007, to each employer that has an obligation to contribute (within the meaning of section 4212(a) of ERISA) to a multiemployer plan. 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 is reasonably 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. The determination is made with respect to individuals who are reasonably expected to be participants or alternate payees in the plan at the effective date of 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 on a typical business day that is reasonably proximate to the time the section 204(h) notice is provided (or at the latest date for providing section 204(h) notice, if earlier), based on all relevant facts and circumstances.

(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. On November 18, 2004, the plan is amended effective as of January 1, 2005 to reduce significantly the rate of future benefit accrual. Section 204(h) notice is provided on November 1, 2004.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, based on the facts and circumstances on November 1, 2004, are reasonably expected to have completed at least 1 year of service and to be employed by the employer on January 1, 2005.

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.

Example 8. (i) *Facts.* A plan is amended to reduce significantly the rate of future benefit accrual for all current employees who are participants. The plan amendment will be effective on January 1, 2004. The plan will provide the notice to applicable individuals on October 31, 2003. In determining which current employees are applicable individuals, the plan administrator determines that October 1, 2003, is a typical business day that is reasonably proximate to the time the section 204(h) notice is provided.

(ii) *Conclusion.* In this case, October 1, 2003 is a typical business day that satisfies the requirements of Q&A–10(e) of this section.

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

A–11. (a) *Explanation of notice requirements*—(1) *In general.* Section 204(h) notice must include sufficient information to allow applicable individuals to understand the effect of the plan amendment. In order to satisfy this rule, a plan administrator providing section 204(h) notice must generally satisfy paragraphs (a)(2), (a)(3), (a)(4), (a)(5), and (a)(6) of this Q&A–11. See paragraph (g)(3) of Q&A–9 of this section for special rules relating to section 204(h) notices provided in connection with certain other written notices. *See* also paragraph (g)(4) of Q&A–9 of

this section for a delegation of authority to the Commissioner to provide special rules.

(2) *Information in section 204(h) notice.* The information in a section 204(h) notice 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.

(3) *Required narrative description of amendment*—(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 the change and specify the factors that apply in calculating the actuarial reduction (for example, a 5% per year reduction applies for early retirement before age 60).

(4) *Sufficient information to determine the approximate magnitude of reduction*—(i) *General rule.* (A) Section 204(h) notice must include sufficient information for each applicable individual to determine the approximate magnitude of the expected reduction for that individual. Thus, in any case in which it is not reasonable to expect that the approximate magnitude of the reduction for each applicable individual will be reasonably apparent from the description of the amendment provided in accordance with paragraph (a)(3) of this Q&A–11, further information is required. The further information may be provided by furnishing additional narrative information or in other information that satisfies this paragraph of this section.

(B) 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.

(ii) *Illustrative examples*—(A) *Requirement generally.* The requirement to include sufficient information for each applicable individual to determine the approximate magnitude of the expected reduction for that individual under (a)(4)(i)(A) of this Q&A–11 is deemed satisfied if the notice includes one or more illustrative examples showing the approximate magnitude of the reduction in the examples, as provided in this paragraph (a)(4)(ii). Illustrative examples are in any event required to be provided for any 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 (either among participants, as would occur for an amendment converting a traditional defined benefit formula to a cash balance formula, or over time as to any individual participant, as would occur for an amendment that results in a wear-away period), the illustrative example(s) provided in accordance with this paragraph (a)(4)(ii) 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 provided under this paragraph (a)(4)(ii) 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 (for example, 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.

(D) *Individual statements.* This paragraph (a)(4)(ii) may be satisfied by providing a statement to each applicable individual projecting what that individual's future benefits are reasonably expected to be at various future dates and what that individual's future benefits would have been under the terms of the plan as in effect before the section 204(h) amendment, provided that the statement includes the same information required for examples under paragraphs (a)(4)(ii)(A) through (C) of this Q&A–11, including showing the approximate range of the reductions for the individual if the reductions vary over time and identification of the assumptions used in the projections.

(5) *No false or misleading information.* A section 204(h) notice may not include materially false or misleading information (or omit information so as to cause the information provided to be misleading).

(6) *Additional information when reduction not uniform*—(i) *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.

(ii) *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.

(b) *Examples*. The following examples illustrate the requirements paragraph (a) of this Q&A–11. In each example, it is assumed that the actual notice provided 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 in accordance with paragraph (a)(2) of this Q&A–11. The examples are as follows:

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 January 1, 2004 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 December 31, 2003. 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 multiplied by 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. The notice does not contain any additional information.

(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 multiplied by 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 multiplied by 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. The notice does not contain any additional information.

(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 multiplied by 1.5 percent multiplied by 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 before July 1, 2005 (taking into account only service and highest 3-year pay before July 1, 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 multiplied by 1.5 percent multiplied by 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 reasonably 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 multiplied by 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 multiplied by 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) and (i)(D) of this *Example 4,* satisfies the requirements of paragraph (a)(3) of this Q&A–11 with respect to applicable individuals who are participants. The requirements of paragraph (a)(4) 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 in paragraph (a)(4)(ii) of this Q&A–11 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 (D) of *Example 4* and paragraph (i) of this *Example 5*, satisfies the requirements of paragraph (a)(3) of this Q&A–11 with respect to applicable individuals who are participants. The requirements of paragraph (a)(4) 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)(4)(ii) of this Q&A–11 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 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) *Delivering section 204(h) notice.* 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 section 204(h) notice is delivered using an electronic medium (other than an oral communication or a recording of an oral communication) under an electronic system that satisfies the applicable notice requirements of § 1.401(a)–21.

(iii) *Special effective date*. For plan years beginning prior to January 1, 2007, Q&A–13 of this section, as it appeared in the April 1, 2006 edition of 26 CFR part 1, applies.

(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 paragraphs (c)(1)(ii) 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 constitute section 204(h) notice 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 constitute section 204(h) notice 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.

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 4980F, section 204(h), 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 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 and by first-class mail for any other applicable individual and to any employee organization representing applicable individuals. 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 defined benefit 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 and section 204(h)?

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 and section 204(h).

(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 whether or not the plan is terminated on that date.'' 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 nor section 204(h) 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 and section 204(h) not later than the termination date (or date of termination, as applicable) established under section 4048 of ERISA. Accordingly, neither section 4980F nor section 204(h) 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 and section 204(h). 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 are the effective dates of section 4980F, section 204(h), as amended by EGTRRA, and these regulations?

A–18. (a) *Statutory effective date*—(1) *General rule*. Section 4980F and section 204(h), 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), 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), 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 and section 204(h), 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.

(4) *Special effective date for certain section 204(h) amendments made by plans of commercial airlines.* Section 402 of PPA '06 applies to section 204(h) amendments adopted in plan years ending after August 17, 2006.

(5) *Special effective date for rule relating to contributing employers.* Section 502(c) of PPA '06, which amended section 4980F(e)(1) of the Internal Revenue Code, applies to section 204(h) amendments adopted in plan years beginning after December 31, 2007.

(b) *Regulatory effective date*—(1) *General effective date.* Except as otherwise provided in this paragraph (b) of this section, Q&A–1 through Q&A–18 of this section apply to amendments with an effective date that is on or after September 1, 2003.

(2) *Effective date for Q&A–7(a)(2).* Q&A–7(a)(2) of this section applies to amendments with an effective date that is on or after January 1, 2004.

(3) *Effective dates for Q&A–9(g)(1), (g)(3), and (g)(4)*—(i) *General effective date.* Except as otherwise provided in Q&A–18(b)(3)(ii) or (b)(3)(iii) of this section, Q&A–9(g)(1), (g)(3), and (g)(4) of this section apply to amendments that are effective on or after January 1, 2008.

(ii) *Effective dates for Q&A–9(g)(2) and Q&A–7(b).* Except as otherwise provided in Q&A–18(b)(3)(iii) of this section, Q&A–9(g)(2) and Q&A–7(b) of this section apply to section 204(h) amendments adopted in plan years beginning after July 1, 2008.

(iii) *Special rules for section 204(h) amendments to an applicable defined benefit plan.* Except as otherwise provided in paragraph (b)(3)(i) or (b)(3)(ii) of this Q&A–18, with respect to any section 204(h) notice provided in connection with a section 204(h) amendment to an applicable defined benefit plan within the meaning of section 411(a)(13)(C)(i) to limit distributions as permitted under section 411(a)(13)(A) for distributions made after August 17, 2006, that is made pursuant to section 701 of PPA '06, paragraphs (g)(1) and (g)(2) of Q&A–9 of this section apply to amendments that are effective after December 21, 2006. For such an amendment that is effective not later than December 31, 2008, section 204(h) notice does not fail to be timely if the notice is provided at least 30 days, rather than 45 days, before the date that the amendment is first effective.

(c) *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.

[T.D. 9052, 68 FR 17281, Apr. 9, 2003, as amended by T.D. 9219, 70 FR 47126, Aug. 12, 2005; T.D. 9294, 71 FR 61888, Oct. 20, 2006; T.D. 9472, 74 FR 61276, Nov. 24, 2009]

§ 54.4980G–0 Table of contents.

This section contains the questions for §§ 54.4980G–1, 54.4980G–2, 54.4980G–3, 54.4980G–4, and 54.4980G–5.

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Q–1: What are the comparability rules that apply to employer contributions to Health Savings Accounts (HSAs)?

Q–2: What are the categories of HDHP coverage for purposes of applying the comparability rules?

Q–3: What is the testing period for making comparable contributions to employees' HSAs?

Q–4: How is the excise tax computed if employer contributions do not satisfy the comparability rules for a calendar year?

§ 54.4980G–2 Employer contribution defined.

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§ 54.4980G–3 Employee for comparability testing.

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Q–9: Does an employer that makes HSA contributions only for one class of non-collectively bargained employees who are eligible individuals, but not for another class of non-collectively bargained employees who are eligible individuals (for example, management v. non-management) satisfy the requirement that the employer make comparable contributions?

Q–10: If an employer contributes to the HSAs of former employees who are eligible individuals, do the comparability rules apply to these contributions?

Q–11: Is an employer permitted to make comparable contributions only to the HSAs of comparable participating former employees who have coverage under the employer's HDHP?

Q–12: If an employer contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP, must the employer make comparable contributions to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1))?

Q–13: How do the comparability rules apply if some employees have HSAs and other employees have Archer MSAs?

§ 54.4980G–4 Calculating comparable contributions.

Q–1: What are comparable contributions?

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Q–4: May an employer make contributions for the entire year to the HSAs of its employees who are eligible individuals at the beginning of the calendar year (*i.e.*, on a prefunded basis) instead of contributing on a pay-as-you-go or on a look-back basis?

Q–5: Must an employer use the same contribution method as described in Q & A–2 and Q & A–4 of this section for all employees for any month during the calendar year?

Q–6: How does an employer comply with the comparability rules if an employee has not established an HSA at the time the employer contributes to its employees' HSAs?

Q–7: If an employer bases its contributions on a percentage of the HDHP deductible, how is the correct percentage or dollar amount computed?

Q–8: Does an employer that contributes to the HSA of each comparable participating employee in an amount equal to the employee's HSA contribution or a percentage of the employee's HSA contribution (matching contributions) satisfy the rule that all comparable participating employees receive comparable contributions?

Q–9: If an employer conditions contributions by the employer to an employee's HSA on an employee's participation in health assessments, disease management programs or

wellness programs and makes the same contributions available to all employees who participate in the programs, do the contributions satisfy the comparability rules?

Q–10: If an employer makes additional contributions to the HSAs of all comparable participating employees who have attained a specified age or who have worked for the employer for a specified number of years, do the contributions satisfy the comparability rules?

Q–11: If an employer makes additional contributions to the HSAs of all comparable participating employees who are eligible to make the additional contributions (HSA catch-up contributions) under section 223(b)(3), do the contributions satisfy the comparability rules?

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Q–16: What is the effective date for the rules in Q & A–14 and Q & A–15 of this section?

§ 54.4980G–5 HSA comparability rules and cafeteria plans and waiver of excise tax.

Q–1: If an employer makes contributions through a section 125 cafeteria plan to the HSA of each employee who is an eligible individual, are the contributions subject to the comparability rules?

Q–2: If an employer makes contributions through a cafeteria plan to the HSA of each employee who is an eligible individual in an amount equal to the amount of the employee's HSA contribution or a percentage of the amount of the employee's HSA contribution (*i.e.*, matching contributions), are the contributions subject to the section 4980G comparability rules?

Q–3: If under the employer's cafeteria plan, employees who are eligible individuals and who participate in health assessments, disease management programs or wellness programs receive an employer contribution to an HSA and the employees have the right to elect to make pre-tax salary reduction contributions to their HSAs, are the contributions subject to the comparability rules?

Q–4: May all or part of the excise tax imposed under section 4980G be waived?

[T.D. 9277, 71 FR 43058, July 31, 2006; 71 FR 53967, Sept. 13, 2006, as amended by T.D. 9393, 73 FR 20795, Apr. 17, 2008]

§ 54.4980G–1 Failure of employer to make comparable health savings account contributions.

Q–1: What are the comparability rules that apply to employer contributions to Health Savings Accounts (HSAs)?

A–1: If an employer makes contributions to any employee's HSA, the employer must make comparable contributions to the HSAs of all comparable participating employees. See Q & A–1 in § 54.4980G–4 for the definition of comparable contributions. Comparable participating employees are eligible individuals (as defined in section 223(c)(1)) who are in the same category of employees and who have the same category of high deductible health plan (HDHP) coverage. See sections 4980G(b) and 4980E(d)(3). See section 223(c)(2) and (g) for the definition of an HDHP. See also Q & A–5 in § 54.4980G–3 for the categories of employees and Q & A–2 of this section for the categories of HDHP coverage. But *see* Q & A–6 in § 54.4980G–3 for treatment of collectively bargained employees and Q & A–1 in § 54.4980G–6 for the rules allowing larger comparable contributions to non-highly compensated employees.

Q–2: What are the categories of HDHP coverage for purposes of applying the comparability rules?

A–2: (a) *In general.* Generally, the categories of coverage are self-only HDHP coverage and family HDHP coverage. Family HDHP coverage means any coverage other than self-only HDHP coverage. The comparability rules apply separately to self-only HDHP coverage and family HDHP coverage. In addition, if an HDHP has family coverage options meeting the descriptions listed in paragraph (b) of this Q & A–2, each such coverage option may be treated as a separate category of coverage and the comparability rules may be applied separately to each category. However, if the HDHP has more than one category that provides coverage for the same number of individuals, all such

categories are treated as a single category for purposes of the comparability rules. Thus, the categories of ''employee plus spouse'' and ''employee plus dependent,'' each providing coverage for two individuals, are treated as the single category ''self plus one'' for comparability purposes. See, however, the final sentence of paragraph (a) of Q & A–1 of § 54.4980G–4 for a special rule that applies if different amounts are contributed for different categories of family coverage. *See also* § 54.4980G–6 for the rules allowing larger comparable contributions to nonhighly compensated employees.

(b) *HDHP Family coverage categories*. The coverage categories are—

(1) Self plus one;

(2) Self plus two; and

(3) Self plus three or more.

(c) *Examples*. The rules of this Q & A–2 are illustrated by the following examples:

Example 1. Employer A maintains an HDHP and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has self-only coverage and family coverage. Thus, the categories of coverage are self-only and family coverage. Employer A contributes $750 to the HSA of each eligible employee with self-only HDHP coverage and $1,000 to the HSA of each eligible employee with family HDHP coverage. Employer A's contributions satisfy the comparability rules.

Example 2. (i) Employer B maintains an HDHP and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has the following coverage options:

(A) Self-only;

(B) Self plus spouse;

(C) Self plus dependent;

(D) Self plus spouse plus one dependent;

(E) Self plus two dependents; and

(F) Self plus spouse and two or more dependents.

(ii) The self plus spouse category and the self plus dependent category constitute the same category of HDHP coverage (self plus one) and Employer B must make the same comparable contributions to the HSAs of all eligible individuals who are in either the self plus spouse category of HDHP coverage or the self plus dependent category of HDHP coverage. Likewise, the self plus spouse plus one dependent category and the self plus two dependents category constitute the same category of HDHP coverage (self plus two) and Employer B must make the same comparable contributions to the HSAs of all eligible individuals who are in either the self plus spouse plus one dependent category of HDHP coverage or the self plus two dependents category of HDHP coverage.

Example 3. (i) Employer C maintains an HDHP and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has the following coverage options:

(A) Self-only;

(B) Self plus one;

(C) Self plus two; and

(D) Self plus three or more.

(ii) Employer C contributes $500 to the HSA of each eligible employee with self-only HDHP coverage, $750 to the HSA of each eligible employee with self plus one HDHP coverage, $900 to the HSA of each eligible employee with self plus two HDHP coverage and $1,000 to the HSA of each eligible employee with self plus three or more HDHP coverage. Employer C's contributions satisfy the comparability rules.

Q–3: What is the testing period for making comparable contributions to employees' HSAs?

A–3: To satisfy the comparability rules, an employer must make comparable contributions for the calendar year to the HSAs of employees who are comparable participating employees. See section 4980G(a). See Q & A–3 and Q & A–4 in § 54.4980G–4 for a discussion of HSA contribution methods.

Q–4: How is the excise tax computed if employer contributions do not satisfy the comparability rules for a calendar year?

A–4: (a) *Computation of tax*. If employer contributions do not satisfy the comparability rules for a calendar year, the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to HSAs for that period.

(b) *Example*. The following example illustrates the rules in paragraph (a) of this Q & A–4:

Example. During the 2007 calendar year, Employer D has 8 employees who are eligible individuals with self-only coverage under an HDHP provided by Employer D. The deductible for the HDHP is $2,000. For the 2007 calendar year, Employer D contributes $2,000 each to the HSAs of two employees and $1,000 each to the HSAs of the other six employees, for total HSA contributions of $10,000. Employer D's contributions do not satisfy the comparability rules. Therefore, Employer D is subject to an excise tax of $3,500 (35% of $10,000) for its failure to make comparable contributions to its employees' HSAs.

Q–5: If a person is liable for the excise tax under section 4980G, what form must the person file and what is the due date for the filing and payment of the excise tax?

A–5: (a) *In general*. §§ 54.6011–2, 54.6151–1 and 54.6071–1(d).

(b) *Effective/applicability date*. The rules in this Q & A–5 are effective for employer contributions made for calendar years beginning on or after January 1, 2010.

[T.D. 9277, 71 FR 43058, July 31, 2006, as amended by T.D. 9457, 74 FR 45997, Sept. 8, 2009]

§ 54.4980G–2 Employer contribution defined.

Q–1: Do the comparability rules apply to amounts rolled over from an employee's HSA or Archer Medical Savings Account (Archer MSA)?

A–1: No. The comparability rules do not apply to amounts rolled over from an employee's HSA or Archer MSA.

Q–2: If an employee requests that his or her employer deduct after-tax amounts from the employee's compensation and forward these amounts as employee contributions to the employee's HSA, do the comparability rules apply to these amounts?

A–2: No. Section 106(d) provides that amounts contributed by an employer to an eligible employee's HSA shall be treated as employer-provided coverage for medical expenses and are excludible from the employee's gross income up to the limit in section 223(b). After-tax employee contributions to an HSA are not subject to the comparability rules because they are not employer contributions under section 106(d).

[T.D. 9277, 71 FR 43058, July 31, 2006]

§ 54.4980G–3 Failure of employer to make comparable health savings account contributions.

Q–1: Do the comparability rules apply to contributions that an employer makes to the HSAs of independent contractors or self-employed individuals?

A–1: No. The comparability rules apply only to contributions that an employer makes to the HSAs of employees.

Q–2: May a sole proprietor who is an eligible individual contribute to his or her own HSA without contributing to the HSAs of his or her employees who are eligible individuals?

A–2: (a) *Sole proprietor not an employee*. Yes. The comparability rules apply only to contributions made by an employer to the HSAs of employees. Because a sole proprietor is not an employee, the comparability rules do not apply to contributions the sole proprietor makes to his or her own HSA. However, if a sole proprietor contributes to any employee's HSA, the sole proprietor must make comparable contributions to the HSAs of all comparable participating employees. In determining whether the comparability rules are satisfied, contributions that a sole proprietor makes to his or her own HSA are not taken into account.

(b) *Example*. The following example illustrates the rules in paragraph (a) of this Q & A–2:

Example. In a calendar year, B, a sole proprietor is an eligible individual and contributes $1,000 to B's own HSA. B also contributes $500 for the same calendar year to the HSA of each employee who is an eligible individual. The comparability rules are not violated by B's $1,000 contribution to B's own HSA.

Q–3: Do the comparability rules apply to contributions by a partnership to a partner's HSA?

A–3: (a) *Partner not an employee*. No. Contributions by a partnership to a bona fide partner's HSA are not subject to the comparability rules because the contributions are not contributions by an employer to the HSA of an employee. The contributions are treated as either guaranteed payments under section 707(c) or distributions under section 731. However, if a partnership contributes to the HSAs of any employee who is not a partner, the partnership must make comparable contributions to the HSAs of all comparable participating employees.

(b) *Example*. The following example illustrates the rules in paragraph (a) of this Q & A–3:

Example. (i) Partnership X is a limited partnership with three equal individual partners, A (a general partner), B (a limited partner), and C (a limited partner). C is to be paid $300 annually for services rendered to Partnership X in her capacity as a partner without regard to partnership income (a section 707(c) guaranteed payment). D and E are the only employees of Partnership X and are

not partners in Partnership X. A, B, C, D, and E are eligible individuals and each has an HSA. During Partnership X's Year 1 taxable year, which is also a calendar year, Partnership X makes the following contributions—

(A) A $300 contribution to each of A's and B's HSAs which are treated as section 731 distributions to A and B;

(B) A $300 contribution to C's HSA in lieu of paying C the guaranteed payment directly; and

(C) A $200 contribution to each of D's and E's HSAs, who are comparable participating employees.

(ii) Partnership X's contributions to A's and B's HSAs are section 731 distributions, which are treated as cash distributions. Partnership X's contribution to C's HSA is treated as a guaranteed payment under section 707(c). The contribution is not excludible from C's gross income under section 106(d) because the contribution is treated as a distributive share of partnership income for purposes of all Code sections other than sections 61(a) and 162(a), and a guaranteed payment to a partner is not treated as compensation to an employee. Thus, Partnership X's contributions to the HSAs of A, B, and C are not subject to the comparability rules. Partnership X's contributions to D's and E's HSAs are subject to the comparability rules because D and E are employees of Partnership X and are not partners in Partnership X. Partnership X's contributions satisfy the comparability rules.

Q–4: How are members of controlled groups treated when applying the comparability rules?

A–4: All persons or entities treated as a single employer under section 414 (b), (c), (m), or (o) are treated as one employer. See sections 4980G(b) and 4980E(e).

Q–5: What are the categories of employees for comparability testing?

A–5: (a) *Categories*. The categories of employees for comparability testing are as follows (but *see* Q & A–6 of this section for the treatment of collectively bargained employees and Q & A–1 of § 54.4980G–6 for a special rule for contributions made to the HSAs of nonhighly compensated employees)—

(1) Current full-time employees;

(2) Current part-time employees; and

(3) Former employees (except for former employees with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1)).

(b) *Part-time and full-time employees*. For purposes of section 4980G, part-time employees are customarily employed for fewer than 30 hours per week and full-time employees are customarily employed for 30 or more hours per week. See sections 4980G(b) and 4980E(d)(4)(A) and (B).

(c) *In general*. Except as provided in Q & A–6 of this section, the categories of employees in paragraph (a) of this Q & A–5 are the exclusive categories of employees for comparability testing. An employer must make comparable contributions to the HSAs of all comparable participating employees (eligible individuals who are in the same category of employees with the same category of HDHP coverage) during the calendar year without regard to any classification other than these categories. For example, full-time eligible employees with self-only HDHP coverage and part-time eligible employees with self-only HDHP coverage are separate categories of employees and different amounts can be contributed to the HSAs for each of these categories. But *see* § 54.4980G–6 for a special rule for contributions made to the HSAs of nonhighly compensated employees.

Q–6: Are employees who are included in a unit of employees covered by a collective bargaining agreement comparable participating employees?

A–6: (a) *In general*. No. Collectively bargained employees who are covered by a bona fide collective bargaining agreement between employee representatives and one or more employers are not comparable participating employees, if health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. Former employees covered by a collective bargaining agreement also are not comparable participating employees.

(b) *Examples*. The following examples illustrate the rules in paragraph (a) of this Q & A–6. The examples read as follows:

Example 1. Employer A offers its employees an HDHP with a $1,500 deductible for self-only coverage. Employer A has collectively bargained and non-collectively bargained employees. The collectively bargained employees are covered by a collective bargaining agreement under which health benefits were bargained in good faith. In the 2007

calendar year, Employer A contributes $500 to the HSAs of all eligible non-collectively bargained employees with self-only coverage under Employer A's HDHP. Employer A does not contribute to the HSAs of the collectively bargained employees. Employer A's contributions to the HSAs of non-collectively bargained employees satisfy the comparability rules. The comparability rules do not apply to collectively bargained employees.

Example 2. Employer B offers its employees an HDHP with a $1,500 deductible for self-only coverage. Employer B has collectively bargained and non-collectively bargained employees. The collectively bargained employees are covered by a collective bargaining agreement under which health benefits were bargained in good faith. In the 2007 calendar year and in accordance with the terms of the collective bargaining agreement, Employer B contributes to the HSAs of all eligible collectively bargained employees. Employer B does not contribute to the HSAs of the non-collectively bargained employees. Employer B's contributions to the HSAs of collectively bargained employees are not subject to the comparability rules because the comparability rules do not apply to collectively bargained employees. Accordingly, Employer B's failure to contribute to the HSAs of the non-collectively bargained employees does not violate the comparability rules.

Example 3. Employer C has two units of collectively bargained employees—unit Q and unit R—each covered by a collective bargaining agreement under which health benefits were bargained in good faith. In the 2007 calendar year and in accordance with the terms of the collective bargaining agreement, Employer C contributes to the HSAs of all eligible collectively bargained employees in unit Q. In accordance with the terms of the collective bargaining agreement, Employer C makes no HSA contributions for collectively bargained employees in unit R. Employer C's contributions to the HSAs of collectively bargained employees are not subject to the comparability rules because the comparability rules do not apply to collectively bargained employees.

Example 4. Employer D has a unit of collectively bargained employees that are covered by a collective bargaining agreement under which health benefits were bargained in good faith. In accordance with the terms of the collective bargaining agreement, Employer D contributes an amount equal to a specified number of cents per hour for each hour worked to the HSAs of all eligible collectively bargained employees. Employer D's contributions to the HSAs of collectively bargained employees are not subject to the comparability rules because the comparability rules do not apply to collectively bargained employees.

Q–7: Is an employer permitted to make comparable contributions only to the HSAs of comparable participating employees who have coverage under the employer's HDHP?

A–7: (a) *Employer-provided HDHP coverage.* If during a calendar year, an employer contributes to the HSA of any employee who is an eligible individual covered under an HDHP provided by the employer, the employer is required to make comparable contributions to the HSAs of all comparable participating employees with coverage under any HDHP provided by the employer. An employer that contributes only to the HSAs of employees who are eligible individuals with coverage under the employer's HDHP is not required to make comparable contributions to HSAs of employees who are eligible individuals but are not covered under the employer's HDHP.

(b) *Non-employer provided HDHP coverage.* An employer that contributes to the HSA of any employee who is an eligible individual with coverage under any HDHP that is not an HDHP provided by the employer, must make comparable contributions to the HSAs of all comparable participating employees whether or not covered under the employer's HDHP. An employer that makes a reasonable good faith effort to identify all comparable participating employees with non-employer provided HDHP coverage and makes comparable contributions to the HSAs of such employees satisfies the requirements in paragraph (b) of this Q & A–7.

(c) *Examples.* The following examples illustrate the rules in this Q & A–7. None of the employees in the following examples are covered by a collective bargaining agreement. The examples read as follows:

Example 1. In a calendar year, Employer E offers an HDHP to its full-time employees. Most full-time employees are covered under Employer E's HDHP and Employer E makes comparable contributions only to these employees' HSAs. Employee W, a full-time employee of Employer E and an eligible individual, is covered under an HDHP provided by the employer of W's spouse and not under Employer E's HDHP. Employer E is not required to make comparable contributions to W's HSA.

Example 2. In a calendar year, Employer F does not offer an HDHP. Several full-time employees of Employer F, who are eligible individuals, have HSAs. Employer F contributes to these employees' HSAs. Employer F must make comparable contributions to the HSAs of all full-time employees who are eligible individuals.

Example 3. In a calendar year, Employer G offers an HDHP to its full-time employees. Most full-time employees are covered under Employer G's HDHP and Employer G makes comparable contributions to these employees' HSAs and also to the HSAs of full-time employees who are eligible individuals and who are not covered under Employer G's HDHP. Employee S, a full-time employee of Employer G and a comparable participating employee, is covered under an HDHP provided by the employer of S's spouse and not under Employer G's HDHP. Employer G must make comparable contributions to S's HSA.

Q–8: If an employee and his or her spouse are eligible individuals who work for the same employer and one employee-spouse has family coverage for both employees under the employer's HDHP, must the employer make comparable contributions to the HSAs of both employees?

A–8: (a) *In general.* If the employer makes contributions only to the HSAs of employees who are eligible individuals covered under its HDHP where only one employee-spouse has family coverage for both employees under the employer's HDHP, the employer is not required to contribute to the HSAs of both employee-spouses. The employer is required to contribute to the HSA of the employee-spouse with coverage under the employer's HDHP, but is not required to contribute to the HSA of the employee-spouse covered under the employer's HDHP by virtue of his or her spouse's coverage. However, if the employer contributes to the HSA of any employee who is an eligible individual with coverage under an HDHP that is not an HDHP provided by the employer, the employer must make comparable contributions to the HSAs of both employee-spouses if they are both eligible individuals. If an employer is required to contribute to the HSAs of both employee-spouses, the employer is not required to contribute amounts in excess of the annual contribution limits in section 223(b).

(b) *Examples.* The following examples illustrate the rules in paragraph (a) of this Q & A–8. None of the employees in the following examples are covered by a collective bargaining agreement. The examples read as follows:

Example 1. In a calendar year, Employer H offers an HDHP to its full-time employees. Most full-time employees are covered under Employer H's HDHP and Employer H makes comparable contributions only to these employees' HSAs. T and U are a married couple. Employee T, who is a full-time employee of Employer H and an eligible individual, has family coverage under Employer H's HDHP for T and T's spouse. Employee U, who is also a full-time employee of Employer H and an eligible individual, does not have coverage under Employer H's HDHP except as the spouse of Employee T. Employer H is required to make comparable contributions to T's HSA, but is not required to make comparable contributions to U's HSA.

Example 2. In a calendar year, Employer J offers an HDHP to its full-time employees. Most full-time employees are covered under Employer J's HDHP and Employer J makes comparable contributions to these employees' HSAs and to the HSAs of full-time employees who are eligible individuals but are not covered under Employer J's HDHP. R and S are a married couple. Employee S, who is a full-time employee of Employer J and an eligible individual, has family coverage under Employer J's HDHP for S and S's spouse. Employee R, who is also a full-time employee of Employer J and an eligible individual, does not have coverage under Employer J's HDHP except as the spouse of Employee S. Employer J must make comparable contributions to S's HSA and to R's HSA.

Q–9: Does an employer that makes HSA contributions only for one class of non-collectively bargained employees who are eligible individuals, but not for another class of non-collectively bargained employees who are eligible individuals (for example, management v. non-management) satisfy the requirement that the employer make comparable contributions?

A–9: (a) *Different classes of employees.*

No. If the two classes of employees are comparable participating employees, the comparability rules are not satisfied. The only categories of employees for comparability purposes are current full-time employees, current part-time employees, and former employees. Collectively bargained employees are not comparable participating employees. But see Q & A–1 in

54.4980G–5 on contributions made through a cafeteria plan. *See* § 54.4980G–6 for a special rule for contributions made to the HSAs of nonhighly compensated employees.

(b) *Examples*. The following examples illustrate the rules in paragraph (a) of this Q & A–9. None of the employees in the following examples are covered by a collective bargaining agreement. The examples read as follows:

Example 1. In a calendar year, Employer K maintains an HDHP covering all management and non-management employees. Employer K contributes to the HSAs of non-management employees who are eligible individuals covered under its HDHP. Employer K does not contribute to the HSAs of its management employees who are eligible individuals covered under its HDHP. The comparability rules are not satisfied.

Example 2. All of Employer L's employees are located in city X and city Y. In a calendar year, Employer L maintains an HDHP for all employees working in city X only. Employer L does not maintain an HDHP for its employees working in city Y. Employer L contributes $500 to the HSAs of city X employees who are eligible individuals with coverage under its HDHP. Employer L does not contribute to the HSAs of any of its city Y employees. The comparability rules are satisfied because none of the employees in city Y are covered under an HDHP of Employer L. (However, if any employees in city Y were covered by an HDHP of Employer L, Employer L could not fail to contribute to their HSAs merely because they work in a different city.)

Example 3. Employer M has two divisions—division N and division O. In a calendar year, Employer M maintains an HDHP for employees working in division N and division O. Employer M contributes to the HSAs of division N employees who are eligible individuals with coverage under its HDHP. Employer M does not contribute to the HSAs of division O employees who are eligible individuals covered under its HDHP. The comparability rules are not satisfied.

Q–10: If an employer contributes to the HSAs of former employees who are eligible individuals, do the comparability rules apply to these contributions?

A–10: (a) *Former employees*. Yes. The comparability rules apply to contributions an employer makes to former employees' HSAs. Therefore, if an employer contributes to any former employee's HSA, it must make comparable contributions to the HSAs of all comparable participating former employees (former employees who are eligible individuals with the same category of HDHP coverage). However, an employer is not required to make comparable contributions to the HSAs of former employees with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1)). See Q & A–5 and Q & A–12 of this section. The comparability rules apply separately to former employees because they are a separate category of covered employee. See Q & A–5 of this section. Also, former employees who were covered by a collective bargaining agreement immediately before termination of employment are not comparable participating employees. See Q & A–6 of this section.

(b) *Locating former employees*. An employer making comparable contributions to former employees must take reasonable actions to locate any missing comparable participating former employees. In general, such actions include the use of certified mail, the Internal Revenue Service Letter Forwarding Program or the Social Security Administration's Letter Forwarding Service.

(c) *Examples*. The following examples illustrate the rules in paragraph (a) of this Q & A–10. None of the employees in the following examples are covered by a collective bargaining agreement. The examples read as follows:

Example 1. In a calendar year, Employer N contributes $1,000 for the calendar year to the HSA of each current employee who is an eligible individual with coverage under any HDHP. Employer N does not contribute to the HSA of any former employee who is an eligible individual. Employer N's contributions satisfy the comparability rules.

Example 2. In a calendar year, Employer O contributes to the HSAs of current employees and former employees who are eligible individuals covered under any HDHP. Employer O contributes $750 to the HSA of each current employee with self-only HDHP coverage and $1,000 to the HSA of each current employee with family HDHP coverage. Employer O also contributes $300 to the HSA of each former employee with self-only HDHP coverage and $400 to the HSA of each former employee with family HDHP coverage. Employer O's contributions satisfy the comparability rules.

Q–11: Is an employer permitted to make comparable contributions only to

the HSAs of comparable participating former employees who have coverage under the employer's HDHP?

A–11: If during a calendar year, an employer contributes to the HSA of any former employee who is an eligible individual covered under an HDHP provided by the employer, the employer is required to make comparable contributions to the HSAs of all former employees who are comparable participating former employees with coverage under any HDHP provided by the employer. An employer that contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP is not required to make comparable contributions to the HSAs of former employees who are eligible individuals and who are not covered under the employer's HDHP. However, an employer that contributes to the HSA of any former employee who is an eligible individual with coverage under an HDHP that is not an HDHP of the employer, must make comparable contributions to the HSAs of all former employees who are eligible individuals whether or not covered under an HDHP of the employer.

Q–12: If an employer contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP, must the employer make comparable contributions to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1))?

A–12: No. An employer that contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP is not required to make comparable contributions to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1)).

Q–13: How do the comparability rules apply if some employees have HSAs and other employees have Archer MSAs?

A–13: (a) *HSAs and Archer MSAs*. The comparability rules apply separately to employees who have HSAs and employees who have Archer MSAs. However, if an employee has both an HSA and an Archer MSA, the employer may contribute to either the HSA or the Archer MSA, but not to both.

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

Example. In a calendar year, Employer P contributes $600 to the Archer MSA of each employee who is an eligible individual and who has an Archer MSA. Employer P contributes $500 for the calendar year to the HSA of each employee who is an eligible individual and who has an HSA. If an employee has both an Archer MSA and an HSA, Employer P contributes to the employee's Archer MSA and not to the employee's HSA. Employee X has an Archer MSA and an HSA. Employer P contributes $600 for the calendar year to X's Archer MSA but does not contribute to X's HSA. Employer P's contributions satisfy the comparability rules.

[T.D. 9277, 71 FR 43058, July 31, 2006, as amended by T.D. 9457, 74 FR 45998, Sept. 8, 2009]

§ 54.4980G–4 Calculating comparable contributions.

Q–1: What are comparable contributions?

A–1: (a) *Definition*. Contributions are comparable if, for each month in a calendar year, the contributions are either the same amount or the same percentage of the deductible under the HDHP for employees who are eligible individuals with the same category of coverage on the first day of that month. Employees with self-only HDHP coverage are tested separately from employees with family HDHP coverage. Similarly, employees with different categories of family HDHP coverage may be tested separately. See Q & A–2 in § 54.4980G–1. An employer is not required to contribute the same amount or the same percentage of the deductible for employees who are eligible individuals with one category of HDHP coverage that it contributes for employees who are eligible individuals with a different category of HDHP coverage. For example, an employer that satisfies the comparability rules by contributing the same amount to the HSAs of all employees who are eligible individuals with family HDHP coverage is not required to contribute any amount to the HSAs of employees who

are eligible individuals with self-only HDHP coverage, or to contribute the same percentage of the self-only HDHP deductible as the amount contributed with respect to family HDHP coverage. However, the contribution with respect to the self plus two category may not be less than the contribution with respect to the self plus one category and the contribution with respect to the self plus three or more category may not be less than the contribution with respect to the self plus two category. But *see* Q & A–1 of § 54.4980G–6 for a special rule for contributions made to the HSAs of nonhighly compensated employees.

(b) *Examples*. The following examples illustrate the rules in paragraph (a) of this Q & A–1. None of the employees in the following examples are covered by a collective bargaining agreement. The examples read as follows:

Example 1. In the 2007 calendar year, Employer A offers its full-time employees three health plans, including an HDHP with self-only coverage and a $2,000 deductible. Employer A contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer A makes no HSA contributions for employees with family HDHP coverage or for employees who do not elect the employer's self-only HDHP. Employer A's HSA contributions satisfy the comparability rules.

Example 2. In the 2007 calendar year, Employer B offers its employees an HDHP with a $3,000 deductible for self-only coverage and a $4,000 deductible for family coverage. Employer B contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer B contributes $2,000 for the calendar year to the HSA of each employee who is an eligible individual electing the family HDHP coverage. Employer B's HSA contributions satisfy the comparability rules.

Example 3. In the 2007 calendar year, Employer C offers its employees an HDHP with a $1,500 deductible for self-only coverage and a $3,000 deductible for family coverage. Employer C contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer C contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the family HDHP coverage. Employer C's HSA contributions satisfy the comparability rules.

Example 4. In the 2007 calendar year, Employer D offers its employees an HDHP with a $1,500 deductible for self-only coverage and a $3,000 deductible for family coverage. Employer D contributes $1,500 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer D contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the family HDHP coverage. Employer D's HSA contributions satisfy the comparability rules.

Example 5. (i) In the 2007 calendar year, Employer E maintains two HDHPs. Plan A has a $2,000 deductible for self-only coverage and a $4,000 deductible for family coverage. Plan B has a $2,500 deductible for self-only coverage and a $4,500 deductible for family coverage. For the calendar year, Employer E makes contributions to the HSA of each full-time employee who is an eligible individual covered under Plan A of $600 for self-only coverage and $1,000 for family coverage. Employer E satisfies the comparability rules, if it makes either of the following contributions for the 2007 calendar year to the HSA of each full-time employee who is an eligible individual covered under Plan B—

(A) $600 for each full-time employee with self-only coverage and $1,000 for each full-time employee with family coverage; or

(B) $750 for each employee with self-only coverage and $1,125 for each employee with family coverage (the same percentage of the deductible Employer E contributes for full-time employees covered under Plan A, 30% of the deductible for self-only coverage and 25% of the deductible for family coverage).

(ii) Employer E also makes contributions to the HSA of each part-time employee who is an eligible individual covered under Plan A of $300 for self-only coverage and $500 for family coverage. Employer E satisfies the comparability rules, if it makes either of the following contributions for the 2007 calendar year to the HSA of each part-time employee who is an eligible individual covered under Plan B—

(A) $300 for each part-time employee with self-only coverage and $500 for each part-time employee with family coverage; or

(B) $375 for each part-time employee with self-only coverage and $563 for each part-time employee with family coverage (the same percentage of the deductible Employer E contributes for part-time employees covered under Plan A, 15% of the deductible for self-only coverage and 12.5% of the deductible for family coverage).

Example 6. (i) In the 2007 calendar year, Employer F maintains an HDHP. The HDHP has the following coverage options—

(A) A $2,500 deductible for self-only coverage;

(B) A $3,500 deductible for self plus one dependent (self plus one);

(C) A $3,500 deductible for self plus spouse (self plus one);

(D) A $3,500 deductible for self plus spouse and one dependent (self plus two); and

(E) A $3,500 deductible for self plus spouse and two or more dependents (self plus three or more).

(ii) Employer F makes the following contributions for the calendar year to the HSA of each full-time employee who is an eligible individual covered under the HDHP—

(A) $750 for self-only coverage;

(B) $1,000 for self plus one dependent;

(C) $1,000 for self plus spouse;

(D) $1,500 for self plus spouse and one dependent; and

(E) $2,000 for self plus spouse and two or more dependents.

(iii) Employer F's HSA contributions satisfy the comparability rules.

Example 7. (i) In a calendar year, Employer G offers its employees an HDHP and a health flexible spending arrangement (health FSA). The health FSA reimburses employees for medical expenses as defined in section 213(d). Some of Employer G's employees have coverage under the HDHP and the health FSA, some have coverage under the HDHP and their spouse's FSA, and some have coverage under the HDHP and are enrolled in Medicare. For the calendar year, Employer G contributes $500 to the HSA of each employee who is an eligible individual. No contributions are made to the HSAs of employees who have coverage under Employer G's health FSA or under a spouse's health FSA or who are enrolled in Medicare.

(ii) The employees who have coverage under a health FSA (whether Employer H's or their spouse's FSA) or who are covered under Medicare are not eligible individuals. Specifically, the employees who have coverage under the health FSA or under a spouse's health FSA are not comparable participating employees because they are not eligible individuals under section 223(c)(1). Similarly, the employees who are enrolled in Medicare are not comparable participating employees because they are not eligible individuals under section 223(b)(7) and (c)(1). Therefore, employees who have coverage under the health FSA or under a spouse's health FSA and employees who are enrolled in Medicare are excluded from comparability testing. See sections 4980G(b) and 4980E. Employer G's contributions satisfy the comparability rules.

Q–2: How does an employer comply with the comparability rules when some non-collectively bargained employees who are eligible individuals do not work for the employer during the entire calendar year?

A–2: (a) *In general.* In determining whether the comparability rules are satisfied, an employer must take into account all full-time and part-time employees who were employees and eligible individuals for any month during the calendar year. (Full-time and part-time employees are tested separately. See Q & A–5 in § 54.4980G–3.) There are two methods to comply with the comparability rules when some employees who are eligible individuals do not work for the employer during the entire calendar year; contributions may be made on a pay-as-you-go basis or on a look-back basis. See Q & A–9 through Q & A–11 in § 54.4980G–3 for the rules regarding comparable contributions to the HSAs of former employees.

(b) *Contributions on a pay-as-you-go basis.* An employer may comply with the comparability rules by contributing amounts at one or more dates during the calendar year to the HSAs of employees who are eligible individuals as of the first day of the month, if contributions are the same amount or the same percentage of the HDHP deductible for employees who are eligible individuals as of the first day of the month with the same category of coverage and are made at the same time. Contributions made at the employer's usual payroll interval for different groups of employees are considered to be made at the same time. For example, if salaried employees are paid monthly and hourly employees are paid bi-weekly, an employer may contribute to the HSAs of hourly employees on a bi-weekly basis and to the HSAs of salaried employees on a monthly basis. An employer may change the amount that it contributes to the HSAs of employees at any point. However, the changed contribution amounts must satisfy the comparability rules.

(c) *Examples.* The following examples illustrate the rules in paragraph (b) of this Q & A–2: The examples read as follows:

Example 1. (i) Beginning on January 1st, Employer H contributes $50 per month on the first day of each month to the HSA of each employee who is an eligible individual on that date. Employer H does not contribute to the HSAs of former employees. In mid-March of the same year, Employee X, an eligible individual, terminates employment after Employer H has contributed $150 to X's HSA. After X terminates employment, Employer H does not contribute additional

amounts to X's HSA. In mid-April of the same year, Employer H hires Employee Y, an eligible individual, and contributes $50 to Y's HSA in May and $50 in June. Effective in July of the same year, Employer H stops contributing to the HSAs of all employees and makes no contributions to the HSA of any employee for the months of July through December. In August, Employer H hires Employee Z, an eligible individual. Employer H does not contribute to Z's HSA. After Z is hired, Employer H does not hire additional employees. As of the end of the calendar year, Employer H has made the following HSA contributions to its employees' HSAs—

(A) Employer H contributed $150 to X's HSA;

(B) Employer H contributed $100 to Y's HSA;

(C) Employer H did not contribute to Z's HSA; and

(D) Employer H contributed $300 to the HSA of each employee who was an eligible individual and employed by Employer J from January through June.

(ii) Employer H's contributions satisfy the comparability rules.

Example 2. In a calendar year, Employer J offers its employees an HDHP and contributes on a monthly pay-as-you-go basis to the HSAs of employees who are eligible individuals with coverage under Employer J's HDHP. In the calendar year, Employer J contributes $50 per month to the HSA of each employee with self-only HDHP coverage and $100 per month to the HSA of each employee with family HDHP coverage. From January 1st through March 31st of the calendar year, Employee X is an eligible individual with self-only HDHP coverage. From April 1st through December 31st of the calendar year, X is an eligible individual with family HDHP coverage. For the months of January, February and March of the calendar year, Employer J contributes $50 per month to X's HSA. For the remaining months of the calendar year, Employer J contributes $100 per month to X's HSA. Employer J's contributions to X's HSA satisfy the comparibility rules.

(d) *Contributions on a look-back basis.* An employer may also satisfy the comparability rules by determining comparable contributions for the calendar year at the end of the calendar year, taking into account all employees who were eligible individuals for any month during the calendar year and contributing the same percentage of the HDHP deductible or the same dollar amount to the HSAs of all employees with the same category of coverage for that month.

(e) *Examples.* The following examples illustrate the rules in paragraph (d) of this Q & A–2. The examples read as follows:

Example 1. In a calendar year, Employer K offers its employees an HDHP and contributes on a look-back basis to the HSAs of employees who are eligible individuals with coverage under Employer K's HDHP. Employer K contributes $600 ($50 per month) for the calendar year to the HSA of each employee with self-only HDHP coverage and $1,200 ($100 per month) for the calendar year to the HSA of each employee with family HDHP coverage. From January 1st through June 30th of the calendar year, Employee Y is an eligible individual with family HDHP coverage. From July 1st through December 31st, Y is an eligible individual with self-only HDHP coverage. Employer K contributes $900 on a look-back basis for the calendar year to Y's HSA ($100) per month for the months of January through June and $50 per month for the months of July through December. Employer K's contributions to Y's HSA satisfy the comparability rules.

Example 2. On December 31st, Employer L contributes $50 per month on a look-back basis to each employee's HSA for each month in the calendar year that the employee was an eligible individual. In mid-March of the same year, Employee T, an eligible individual, terminated employment. In mid-April of the same year, Employer L hired Employee U, who becomes an eligible individual as of May 1st and works for Employer L through December 31st. On December 31st, Employer L contributes $150 to Employee T's HSA and $400 to Employee U's HSA. Employer L's contributions satisfy the comparability rules.

(f) *Periods and dates for making contributions.* With both the pay-as-you-go method and the look-back method, an employer may establish, on a reasonable and consistent basis, periods for which contributions will be made (for example, a quarterly period covering three consecutive months in a calendar year) and the dates on which such contributions will be made for that designated period (for example, the first day of the quarter or the last day of the quarter in the case of an employer who has established a quarterly period for making contributions). An employer that makes contributions on a pay-as-you-go basis for a period covering more than one month will not fail to satisfy the comparability rules because an employee who terminates

employment prior to the end of the period for which contributions were made has received more contributions on a monthly basis than employees who have worked the entire period. In addition, an employer that makes contributions on a pay-as-you-go basis for a period covering more than one month must make HSA contributions for any comparable participating employees hired after the date of initial funding for that period.

(g) *Example*. The following example illustrates the rules in paragraph (f) of this Q & A–2:

Example. Employer M has established, on a reasonable and consistent basis, a quarterly period for making contributions to the HSAs of eligible employees on a pay-as-you-go basis. Beginning on January 1st, Employer M contributes $150 for the first three months of the calendar year to the HSA of each employee who is an eligible individual on that date. On January 15th, Employee V, an eligible individual, terminated employment after Employer M has contributed $150 to V's HSA. On January 15th, Employer M hired Employee W, who becomes an eligible individual as of February 1st. On April 1st, Employer M has contributed $100 to W's HSA for the two months (February and March) in the quarter period that Employee W was an eligible employee. Employer M's contributions satisfy the comparability rules.

(h) *Maximum contribution permitted for all employees who are eligible individuals during the last month of the taxable year*. An employer may contribute up to the maximum annual contribution amount for the calendar year (based on the employees' HDHP coverage) to the HSAs of all employees who are eligible individuals on the first day of the last month of the employees' taxable year, including employees who worked for the employer for less than the entire calendar year and employees who became eligible individuals after January 1st of the calendar year. For example, such contribution may be made on behalf of an eligible individual who is hired after January 1st or an employee who becomes an eligible individual after January 1st. Employers are not required to provide more than a pro-rata contribution based on the number of months that an individual was an eligible individual and employed by the employer during the year. However, if an employer contributes more than a pro-rata amount for the calendar year to the HSA of any eligible individual who is hired after January 1st of the calendar year or any employee who becomes an eligible individual any time after January 1st of the calendar year, the employer must contribute that same amount on an equal and uniform basis to the HSAs of all comparable participating employees (as defined in Q & A–1 in § 54.4980G–1) who are hired or become eligible individuals after January 1st of the calendar year. Likewise, if an employer contributes the maximum annual contribution amount for the calendar year to the HSA of any eligible individual who is hired after January 1st of the calendar year or any employee who becomes an eligible individual any time after January 1st of the calendar year, the employer must contribute the maximum annual contribution amount on an equal and uniform basis to the HSAs of all comparable participating employees (as defined in Q & A–1 in § 54.4980G–1) who are hired or become eligible individuals after January 1st of the calendar year. An employer who makes the maximum calendar year contribution or more than a pro-rata contribution to the HSAs of employees who become eligible individuals after the first day of the calendar year or eligible individuals who are hired after the first day of the calendar year will not fail to satisfy comparability merely because some employees will have received more contributions on a monthly basis than employees who worked the entire calendar year.

(i) *Examples*. The following examples illustrate the rules in paragraph (h) in this Q & A–2. In the following examples, no contributions are made through a section 125 cafeteria plan and none of the employees are covered by a collective bargaining agreement.

Example 1. On January 1, 2010, Employer Q contributes $1,000 for the calendar year to the HSAs of employees who are eligible individuals with family HDHP coverage. In mid-March of the same year, Employer Q hires Employee A, an eligible individual with family HDHP coverage. On April 1, 2010, Employer Q contributes $1,000 to the HSA of Employee A. In September of the same year, Employee B becomes an eligible individual with family HDHP coverage. On October 1, 2010, Employer G contributes $1,000 to the

HSA of Employee B. Employer Q does not make any other contributions for the 2010 calendar year. Employer Q's contributions satisfy the comparability rules.

Example 2. For the 2010 calendar year, Employer R only has two employees, Employee C and Employee D. Employee C, an eligible individual with family HDHP coverage, works for Employer R for the entire calendar year. Employee D, an eligible individual with family HDHP coverage works for Employer R from July 1st through December 31st. Employer R contributes $1,200 for the calendar year to the HSA of Employee C and $600 to the HSA of Employee D. Employer R does not make any other contributions for the 2010 calendar year. Employer R's contributions satisfy the comparability rules.

(j) *Effective/applicability date.* The rules in paragraphs (h) and (i) of Q & A–2 are effective for employer contributions made for calendar years beginning on or after January 1, 2010.

Q–3: How do the comparability rules apply to employer contributions to employees' HSAs if some non-collectively bargained employees work full-time during the entire calendar year, and other non-collectively bargained employees work full-time for less than the entire calendar year?

A–3: Employer contributions to the HSAs of employees who work full-time for less than twelve months satisfy the comparability rules if the contribution amount is comparable when determined on a month-to-month basis. For example, if the employer contributes $240 to the HSA of each full-time employee who works the entire calendar year, the employer must contribute $60 to the HSA of each full-time employee who works on the first day of each three months of the calendar year. The rules set forth in this Q & A–2 apply to employer contributions made on a pay-as-you-go basis or on a look-back basis as described in Q & A–3 of this section. See sections 4980G(b) and 4980E(d)(2)(B).

Q–4: May an employer make contributions for the entire year to the HSAs of its employees who are eligible individuals at the beginning of the calendar year (on a pre-funded basis) instead of contributing on a pay-as-you-go or on a look-back basis?

A–4: (a) *Contributions on a pre-funded basis.* Yes. An employer may make contributions for the entire year to the HSAs of its employees who are eligible individuals at the beginning of the calendar year. An employer that pre-funds the HSAs of its employees will not fail to satisfy the comparability rules because an employee who terminates employment prior to the end of the calendar year has received more contributions on a monthly basis than employees who work the entire calendar year. See Q & A–12 of this section. Under section 223(d)(1)(E), an account beneficiary's interest in an HSA is nonforfeitable. An employer must make comparable contributions for all employees who are comparable participating employees for any month during the calendar year, including employees who are eligible individuals hired after the date of initial funding. An employer that makes HSA contributions on a pre-funded basis may also contribute on a pre-funded basis to the HSAs of employees who are eligible individuals hired after the date of initial funding. Alternatively, an employer that has pre-funded the HSAs of comparable participating employees may contribute to the HSAs of employees who are eligible individuals hired after the date of initial funding on a pay-as-you-go basis or on a look-back basis. An employer that makes HSA contributions on a pre-funded basis must use the same contribution method for all employees who are eligible individuals hired after the date of initial funding.

(b) *Example.* The following example illustrates the rules in paragraph (a) of this Q & A–4:

Example. (i) On January 1, Employer N contributes $1,200 for the calendar year on a pre-funded basis to the HSA of each employee who is an eligible individual. In mid-May, Employer N hires Employee B, who becomes an eligible individual as of June 1st. Therefore, Employer N is required to make comparable contributions to B's HSA beginning in June. Employer N satisfies the comparability rules with respect to contributions to B's HSA if it makes HSA contributions in any one of the following ways—

(A) Pre-funding B's HSA by contributing $700 to B's HSA;

(B) Contributing $100 per month on a pay-as-you-go basis to B's HSA; or

(C) Contributing to B's HSA at the end of the calendar year taking into account each month that B was an eligible individual and employed by Employer M.

(ii) If Employer M hires additional employees who are eligible individuals after initial funding, it must use the same contribution method for these employees that it used to contribute to B's HSA.

Q–5: Must an employer use the same contribution method as described in Q & A–2 and Q & A–4 of this section for all employees who were comparable participating employees for any month during the calendar year?

A–5: Yes. If an employer makes comparable HSA contributions on a pay-as-you-go basis, it must do so for each employee who is a comparable participating employee as of the first day of the month. If an employer makes comparable contributions on a look-back basis, it must do so for each employee who was a comparable participating employee for any month during the calendar year. If an employer makes HSA contributions on a pre-funded basis, it must do so for all employees who are comparable participating employees at the beginning of the calendar year and must make comparable HSA contributions for all employees who are comparable participating employees for any month during the calendar year, including employees who are eligible individuals hired after the date of initial funding. See Q & A–4 of this section for rules regarding contributions for employees hired after initial funding.

Q–6: How does an employer comply with the comparability rules if an employee has not established an HSA at the time the employer contributes to its employees' HSAs?

A–6: (a) *Employee has not established an HSA at the time the employer funds its employees' HSAs.* If an employee has not established an HSA at the time the employer funds its employees' HSAs, the employer complies with the comparability rules by contributing comparable amounts plus reasonable interest to the employee's HSA when the employee establishes the HSA, taking into account each month that the employee was a comparable participating employee. See Q & A–13 of this section for rules regarding reasonable interest.

(b) *Example.* The following example illustrates the rules in paragraph (a) of this Q & A–6:

Example. Beginning on January 1st, Employer O contributes $500 per calendar year on a pay-as-you-go basis to the HSA of each employee who is an eligible individual. Employee C is an eligible individual during the entire calendar year but does not establish an HSA until March. Notwithstanding C's delay in establishing an HSA, Employer O must make up the missed HSA contributions plus reasonable interest for January and February by April 15th of the following calendar year.

Q–7: If an employer bases its contributions on a percentage of the HDHP deductible, how is the correct percentage or dollar amount computed?

A–7: (a) *Computing HSA contributions.* The correct percentage is determined by rounding to the nearest 1/100th of a percentage point and the dollar amount is determined by rounding to the nearest whole dollar.

(b) *Example.* The following example illustrates the rules in paragraph (a) of this Q & A–7:

Example. In this *Example*, assume that each HDHP provided by Employer P satisfies the definition of an HDHP for the 2007 calendar year. In the 2007 calendar year, Employer P maintains two HDHPs. Plan A has a deductible of $3,000 for self-only coverage. Employer P contributes $1,000 for the calendar year to the HSA of each employee covered under Plan A. Plan B has a deductible of $3,500 for self-only coverage. Employer P satisfies the comparability rules if it makes either of the following contributions for the 2007 calendar year to the HSA of each employee who is an eligible individual with self-only coverage under Plan B—

(i) $1,000; or

(ii) $1,167 (33.33% of the deductible rounded to the nearest whole dollar amount).

Q–8: Does an employer that contributes to the HSA of each comparable participating employee in an amount equal to the employee's HSA contribution or a percentage of the employee's HSA contribution (matching contributions) satisfy the rule that all comparable participating employees receive comparable contributions?

A–8: No. If all comparable participating employees do not contribute the same amount to their HSAs and, consequently, do not receive comparable contributions to their HSAs, the comparability rules are not satisfied, notwithstanding that the employer offers

to make available the same contribution amount to each comparable participating employee. But see Q & A–1 in § 54.4980G–5 on contributions to HSAs made through a cafeteria plan.

Q–9: If an employer conditions contributions by the employer to an employee's HSA on an employee's participation in health assessments, disease management programs or wellness programs and makes the same contributions available to all employees who participate in the programs, do the contributions satisfy the comparability rules?

A–9: No. If all comparable participating employees do not elect to participate in all the programs and consequently, all comparable participating employees do not receive comparable contributions to their HSAs, the employer contributions fail to satisfy the comparability rules. But see Q & A–1 in § 54.4980G–5 on contributions made to HSAs through a cafeteria plan.

Q–10: If an employer makes additional contributions to the HSAs of all comparable participating employees who have attained a specified age or who have worked for the employer for a specified number of years, do the contributions satisfy the comparability rules?

A–10: No. If all comparable participating employees do not meet the age or length of service requirement, all comparable participating employees do not receive comparable contributions to their HSAs and the employer contributions fail to satisfy the comparability rules.

Q–11: If an employer makes additional contributions to the HSAs of all comparable participating employees who are eligible to make the additional contributions (HSA catch-up contributions) under section 223(b)(3), do the contributions satisfy the comparability rules?

A–11: No. If all comparable participating employees are not eligible to make the additional HSA contributions under section 223(b)(3), all comparable participating employees do not receive comparable contributions to their HSAs, and the employer contributions fail to satisfy the comparability rules.

Q–12: If an employer's contributions to an employee's HSA result in non-comparable contributions, may the employer recoup the excess amount from the employee's HSA?

A–12: No. An employer may not recoup from an employee's HSA any portion of the employer's contribution to the employee's HSA. Under section 223(d)(1)(E), an account beneficiary's interest in an HSA is nonforfeitable. However, an employer may make additional HSA contributions to satisfy the comparability rules. An employer may contribute up until April 15th following the calendar year in which the non-comparable contributions were made. An employer that makes additional HSA contributions to correct non-comparable contributions must also contribute reasonable interest. However, an employer is not required to contribute amounts in excess of the annual contribution limits in section 223(b). See Q & A–13 of this section for rules regarding reasonable interest.

Q–13: What constitutes a reasonable interest rate for purposes of making comparable contributions?

A–13: The determination of whether a rate of interest used by an employer is reasonable will be based on all of the facts and circumstances. If an employer calculates interest using the Federal short-term rate as determined by the Secretary in accordance with section 1274(d), the employer is deemed to use a reasonable interest rate.

Q–14: Does an employer fail to satisfy the comparability rules for a calendar year if the employer fails to make contributions with respect to eligible employees because the employee has not established an HSA or because the employer does not know that the employee has established an HSA?

A–14: (a) *In general.* An employer will not fail to satisfy the comparability rules for a calendar year (Year 1) merely because the employer fails to make contributions with respect to an eligible employee because the employee has not established an HSA or because the employer does not know that the employee has established an HSA, if—

(1) The employer provides timely written notice to all such eligible employees that it will make comparable contributions for Year 1 for eligible employees who, by the last day of February of the following calendar year

(Year 2), both establish an HSA and notify the employer (in accordance with a procedure specified in the notice) that they have established an HSA; and

(2) For each such eligible employee who establishes an HSA and so notifies the employer on or before the last day of February of Year 2, the employer contributes to the HSA for Year 1 comparable amounts (taking into account each month that the employee was a comparable participating employee) plus reasonable interest by April 15th of Year 2.

(b) *Notice*. The notice described in paragraph (a) of this Q & A–14 must be provided to each eligible employee who has not established an HSA by December 31 of Year 1 or if the employer does not know if the employee established an HSA. The employer may provide the notice to other employees as well. However, if an employee has earlier notified the employer that he or she has established an HSA, or if the employer has previously made contributions to that employee's HSA, the employer may not condition making comparable contributions on receipt of any additional notice from that employee. For each calendar year, a notice is deemed to be timely if the employer provides the notice no earlier than 90 days before the first HSA employer contribution for that calendar year and no later than January 15 of the following calendar year.

(c) *Model notice*. Employers may use the following sample language as a basis in preparing their own notices.

Notice to Employees Regarding Employer Contributions to HSAs:

This notice explains how you may be eligible to receive contributions from [employer] if you are covered by a High Deductible Health Plan (HDHP). [Employer] provides contributions to the Health Savings Account (HSA) of each employee who is [insert employer's eligibility requirements for HSA contributions] (''eligible employee''). If you are an eligible employee, you must do the following in order to receive an employer contribution:

(1) Establish an HSA on or before the last day in February of [insert year after the year for which the contribution is being made] and;

(2) Notify [insert name and contact information for appropriate person to be contacted] of your HSA account information on or before the last day in February of [insert year after year for which the contribution is being made]. [Specify the HSA account information that the employee must provide (e.g., account number, name and address of trustee or custodian, etc.) and the method by which the employee must provide this account information (e.g., in writing, by e-mail, on a certain form, etc.)].

If you establish your HSA on or before the last day of February in [insert year after year for which the contribution is being made] and notify [employer] of your HSA account information, you will receive your HSA contributions, plus reasonable interest, for [insert year for which contribution is being made] by April 15 of [insert year after year for which contribution is being made]. If, however, you do not establish your HSA or you do not notify us of your HSA account information by the deadline, then we are not required to make any contributions to your HSA for [insert applicable year]. You may notify us that you have established an HSA by sending an [e-mail or] a written notice to [insert name, title and, if applicable, e-mail address]. If you have any questions about this notice, you can contact [insert name and title] at [insert telephone number or other contact information].

(d) [Reserved]

(e) *Electronic delivery*. An employer may furnish the notice required under this section electronically in accordance with § 1.401(a)-21 of this chapter.

(f) *Examples*. The following examples illustrate the rules in this Q & A–14:

Example 1. In a calendar year, Employer Q contributes to the HSAs of current employees who are eligible individuals covered under any HDHP. For the 2009 calendar year, Employer Q contributes $50 per month on the first day of each month, beginning January 1st, to the HSA of each employee who is an eligible employee on that date. For the 2009 calendar year, Employer Q provides written notice satisfying the content requirements of this Q & A–14 on October 16, 2008 to all employees regarding the availability of HSA contributions for eligible employees. For eligible employees who are hired after October 16, 2008, Employer Q provides such a notice no later than January 15, 2010. Employer Q's notice satisfies the notice timing requirements in paragraph (a)(1) of this Q & A–14.

Example 2. Employer R's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. Employer R automatically contributes a non-elective matching contribution to the HSA of each employee who makes a pre-tax HSA contribution. Because Employer R's HSA contributions are made

through the cafeteria plan, the comparability requirements do not apply to the HSA contributions made by Employer R. Consequently, Employer R is not required to provide written notice to its employees regarding the availability of this matching HSA contribution. See Q & A–1 in § 54.4980G–5 for treatment of HSA contributions made through a cafeteria plan.

Example 3. In a calendar year, Employer S maintains an HDHP and only contributes to the HSAs of eligible employees who elect coverage under its HDHP. For the 2009 calendar year, Employer S employs ten eligible employees and all ten employees have elected coverage under Employer S's HDHP and have established HSAs. For the 2009 calendar year, Employer S makes comparable contributions to the HSAs of all ten employees. Employer S satisfies the comparability rules. Thus, Employer S is not required to provide written notice to its employees regarding the availability of HSA contributions for eligible employees.

Example 4. In a calendar year, Employer T contributes to the HSAs of current full-time employees with family coverage under any HDHP. For the 2009 calendar year, Employer T provides timely written notice satisfying the content requirements of this section to all employees regardless of HDHP coverage. Employer T makes identical monthly contributions to all eligible employees (meaning full time employees with family HDHP coverage) that establish HSAs. Employer T contributes comparable amounts (taking into account each month that the employee was a comparable participating employee) plus reasonable interest to the HSAs of the eligible employees that establish HSAs and provide the necessary information after the end of the year but on or before the last day of February, 2010. Employer T makes no contribution to the HSAs of employees that do not establish an HSA or that do not provide the necessary information on or before the last day of February, 2010. Employer T satisfies the comparability requirements.

Example 5. For the 2009 calendar year, Employer V contributes to the HSAs of current full time employees with family coverage under any HDHP. Employer V has 500 current full time employees. As of the date for Employer V's first HSA contribution for the 2009 calendar year, 450 eligible employees have established HSAs. Employer V provides timely written notice satisfying the content requirements of this section only to those 50 eligible employees who have not established HSAs. Employer V makes identical quarterly contributions to the 450 eligible employees who established HSAs. By April 15, 2010, Employer V contributes comparable amounts to the other eligible employees who establish HSAs and provide the necessary information on or before the last day of February, 2010. Employer V makes no contribution to the HSAs of eligible employees that do not establish an HSA or that do not provide the necessary information on or before the last day of February, 2010. Employer V satisfies the comparability rules.

Q–15: For any calendar year, may an employer accelerate part or all of its contributions for the entire year to the HSAs of employees who have incurred, during the calendar year, qualified medical expenses (as defined in section 223(d)(2)) exceeding the employer's cumulative HSA contributions at that time?

A–15: (a) *In general.* Yes. For any calendar year, an employer may accelerate part or all of its contributions for the entire year to the HSAs of employees who have incurred, during the calendar year, qualified medical expenses exceeding the employer's cumulative HSA contributions at that time. If an employer accelerates contributions to the HSA of any such eligible employee, all accelerated contributions must be available throughout the calendar year on an equal and uniform basis to all such eligible employees. Employers must establish reasonable uniform methods and requirements for accelerated contributions and the determination of medical expenses.

(b) *Satisfying comparability.* An employer that accelerates contributions to the HSAs of its employees will not fail to satisfy the comparability rules because employees who incur qualifying medical expenses exceeding the employer's cumulative HSA contributions at that time have received more contributions in a given period than comparable employees who do not incur such expenses, provided that all comparable employees receive the same amount or the same percentage for the calendar year. Also, an employer that accelerates contributions to the HSAs of its employees will not fail to satisfy the comparability rules because an employee who terminates employment prior to the end of the calendar year has received more contributions on a monthly basis than employees who work the entire calendar year. An employer is not required to contribute reasonable interest on either accelerated or non-accelerated HSA contributions. But see Q & A–6 and Q &

A–12 of this section for when reasonable interest must be paid.

Q–16: What is the effective date for the rules in Q & A–14 and Q & A–15 of this section?

A–16: These regulations apply to employer contributions made for calendar years beginning on or after January 1, 2009.

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§ 54.4980G–5 HSA comparability rules and cafeteria plans and waiver of excise tax.

Q–1: If an employer makes contributions through a section 125 cafeteria plan to the HSA of each employee who is an eligible individual, are the contributions subject to the comparability rules?

A–1: (a) *In general.* No. The comparability rules do not apply to HSA contributions that an employer makes through a section 125 cafeteria plan. However, contributions to an HSA made through a cafeteria plan are subject to the section 125 nondiscrimination rules (eligibility rules, contributions and benefits tests and key employee concentration tests). See section 125(b), (c) and (g) and the regulations thereunder.

(b) *Contributions made through a section 125 cafeteria plan.* Employer contributions to employees' HSAs are made through a section 125 cafeteria plan and are subject to the section 125 cafeteria plan nondiscrimination rules and not the comparability rules if under the written cafeteria plan, the employees have the right to elect to receive cash or other taxable benefits in lieu of all or a portion of an HSA contribution (meaning that all or a portion of the HSA contributions are available as pre-tax salary reduction amounts), regardless of whether an employee actually elects to contribute any amount to the HSA by salary reduction.

Q–2: If an employer makes contributions through a cafeteria plan to the HSA of each employee who is an eligible individual in an amount equal to the amount of the employee's HSA contribution or a percentage of the amount of the employee's HSA contribution (matching contributions), are the contributions subject to the section 4980G comparability rules?

A–2: No. The comparability rules do not apply to HSA contributions that an employer makes through a section 125 cafeteria plan. Thus, where matching contributions are made by an employer through a cafeteria plan, the contributions are not subject to the comparability rules of section 4980G. However, contributions, including matching contributions, to an HSA made under a cafeteria plan are subject to the section 125 nondiscrimination rules (eligibility rules, contributions and benefits tests and key employee concentration tests). See Q & A–1 of this section.

Q–3: If under the employer's cafeteria plan, employees who are eligible individuals and who participate in health assessments, disease management programs or wellness programs receive an employer contribution to an HSA and the employees have the right to elect to make pre-tax salary reduction contributions to their HSAs, are the contributions subject to the comparability rules?

A–3: (a) *In general.* No. The comparability rules do not apply to employer contributions to an HSA made through a cafeteria plan. See Q & A–1 of this section.

(b) *Examples.* The following examples illustrate the rules in this § 54.4980G–5. The examples read as follows:

Example 1. Employer A's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply because the HSA contributions are made through the cafeteria plan.

Example 2. Employer B's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable

benefits in lieu of their HSA pre-tax contribution. Employer B automatically contributes a non-elective matching contribution or seed money to the HSA of each employee who makes a pre-tax HSA contribution. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply to Employer B's HSA contributions because the HSA contributions are made through the cafeteria plan.

Example 3. Employer C's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. Employer C makes a non-elective contribution to the HSAs of all employees who complete a health risk assessment and participate in Employer C's wellness program. Employees do not have the right to receive cash or other taxable benefits in lieu of Employer C's non-elective contribution. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply to Employer C's HSA contributions because the HSA contributions are made through the cafeteria plan.

Example 4. Employer D's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. Employees participating in the plan who are eligible individuals receive automatic employer contributions to their HSAs. Employees make no election with respect to Employer D's contribution and do not have the right to receive cash or other taxable benefits in lieu of Employer D's contribution but are permitted to make their own pre-tax salary reduction contributions to fund their HSAs. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply to Employer D's HSA contributions because the HSA contributions are made through the cafeteria plan.

Q–4: May all or part of the excise tax imposed under section 4980G be waived?

A–4: In the case of a failure which is due to reasonable cause and not to willful neglect, all or a portion of the excise tax imposed under section 4980G may be waived to the extent that the payment of the tax would be excessive relative to the failure involved. See sections 4980G(b) and 4980E(c).

[T.D. 9277, 71 FR 43058, July 31, 2006]

§ 54.4980G–6 Special rule for contributions made to the HSAs of nonhighly compensated employees.

Q–1: May an employer make larger contributions to the HSAs of nonhighly compensated employees than to the HSAs of highly compensated employees?

A–1: Yes. Employers may make larger HSA contributions for nonhighly compensated employees who are comparable participating employees than for highly compensated employees who are comparable participating employees. *See* Q & A–1 in § 54.4980G–1 for the definition of comparable participating employee. For purposes of this section, highly compensated employee is defined under section 414(q). Nonhighly compensated employees are employees that are not highly compensated employees. The comparability rules continue to apply with respect to contributions to the HSAs of all nonhighly compensated employees. Employers must make comparable contributions for the calendar year to the HSA of each nonhighly compensated employee who is a comparable participating employee.

Q–2: May an employer make larger contributions to the HSAs of highly compensated employees than to the HSAs of nonhighly compensated employees?

A–2: (a) *In general.* No. Employer contributions to HSAs for highly compensated employees who are comparable participating employees may not be larger than employer HSA contributions for nonhighly compensated employees who are comparable participating employees. The comparability rules continue to apply with respect to contributions to the HSAs of all highly compensated employees. Employers must make comparable contributions for the calendar year to the HSA of each highly compensated comparable participating employee. *See* Q & A–1 in § 54.4980G–1 for the definition of comparable participating employee.

(b) *Examples.* The following examples illustrate the rules in Q & A–1 and Q & A–2 of this section. No contributions are made through a section 125 cafeteria plan and none of the employees in the following examples are covered by a collective bargaining agreement. All

of the employees in the following examples have the same HDHP deductible for the same category of coverage.

Example 1. In 2010, Employer A contributes $1,000 for the calendar year to the HSA of each full-time nonhighly compensated employee who is an eligible individual with self-only HDHP coverage. Employer A makes no contribution to the HSA of any full-time highly compensated employee who is an eligible individual with self-only HDHP coverage. Employer A's HSA contributions for calendar year 2010 satisfy the comparability rules.

Example 2. In 2010, Employer B contributes $2,000 for the calendar year to the HSA of each full-time nonhighly compensated employee who is an eligible individual with self-only HDHP coverage. Employer B also contributes $1,000 for the calendar year to the HSA of each full-time highly compensated employee who is an eligible individual with self-only HDHP coverage. Employer B's HSA contributions for calendar year 2010 satisfy the comparability rules.

Example 3. In 2010, Employer C contributes $1,000 for the calendar year to the HSA of each full-time nonhighly compensated employee who is an eligible individual with self-only HDHP coverage. Employer C contributes $2,000 for the calendar year to the HSA of each full-time highly compensated employee who is an eligible individual with self-only HDHP coverage. Employer C's HSA contributions for calendar year 2010 do not satisfy the comparability rules.

Example 4. In 2010, Employer D contributes $1,000 for the calendar year to the HSA of each full-time nonhighly compensated employee who is an eligible individual with self-only HDHP coverage. Employer D also contributes $1,000 to the HSA of each full-time highly compensated employee who is an eligible individual with self-only HDHP coverage. In addition, the employer contributes an additional $500 to the HSA of each nonhighly compensated employee who participates in a wellness program. The nonhighly compensated employees did not receive comparable contributions, and, therefore, Employer D's HSA contributions for calendar year 2010 do not satisfy the comparability rules.

Example 5. In 2010, Employer E contributes $1,000 for the calendar year to the HSA of each full-time non-management nonhighly compensated employee who is an eligible individual with family HDHP coverage. Employer E also contributes $500 for the calendar year to the HSA of each full-time management nonhighly compensated employee who is an eligible individual with family HDHP coverage. The nonhighly compensated employees did not receive comparable contributions, and, therefore, Employer E's HSA contributions for calendar year 2010 do not satisfy the comparability rules.

Q–3: May an employer make larger HSA contributions for employees with self plus two HDHP coverage than employees with self plus one HDHP coverage even if the employees with self plus two are all highly compensated employees and the employees with self plus one are all nonhighly compensated employees?

A–3: (a) Yes. Q & A–1 in § 54.4980G–4 provides that an employer's contribution with respect to the self plus two category of HDHP coverage may not be less than the contribution with respect to the self plus one category and the contribution with respect to the self plus three or more category may not be less than the contribution with respect to the self plus two category. Therefore, the comparability rules are not violated if an employer makes a larger HSA contribution for the self plus two category of HDHP coverage than to self plus one coverage, even if the employees with self plus two coverage are all highly compensated employees and the employees with self plus one coverage are all nonhighly compensated employees. Likewise, the comparability rules are not violated if an employer makes a larger HSA contribution for the self plus three category of HDHP coverage than to self plus two coverage, even if the employees with self plus three coverage are all highly compensated employees and the employees with self plus two coverage are all nonhighly compensated employees.

(b) *Example.* The following example illustrates the rules in paragraph (a) of this Q & A–3. In the following example, no contributions are made through a section 125 cafeteria plan and none of the employees are covered by a collective bargaining agreement.

Example. In 2010, Employer F contributes $1,000 for the calendar year to the HSA of each full-time employee who is an eligible individual with self plus one HDHP coverage. Employer F contributes $1,500 for the calendar year to the HSA of each employee who is an eligible individual with self plus two HDHP coverage. The deductible for both the self plus one HDHP and the self plus two HDHP is $2,000. Employee A, an eligible individual, is a nonhighly compensated employee with self plus one coverage. Employee B, an eligible individual, is a highly compensated

employee with self plus two coverage. For the 2010 calendar year, Employer F contributes $1,000 to Employee A's HSA and $1,500 to Employee B's HSA. Employer F's HSA contributions satisfy the comparability rules.

Q–4:What is the effective date for the rules in this section?

A–4: The rules in this section are effective for employer contributions made for calendar years beginning on or after January 1, 2010.

[T.D. 9457, 74 FR 45998, Sept. 8, 2009]

§ 54.4980G–7 Special comparability rules for qualified HSA distributions contributed to HSAs on or after December 20, 2006 and before January 1, 2012.

Q–1 How do the comparability rules of section 4980G apply to qualified HSA distributions under section 106(e)(2)?

A–1:The comparability rules of section 4980G do not apply to amounts contributed to employee HSAs through qualified HSA distributions. However, in order to satisfy the comparability rules, if an employer offers qualified HSA distributions, as defined in section 106(e)(2), to any employee who is an eligible individual covered under any HDHP, the employer must offer qualified HSA distributions to all employees who are eligible individuals covered under any HDHP. However, if an employer offers qualified HSA distributions only to employees who are eligible individuals covered under the employer's HDHP, the employer is not required to offer qualified HSA distributions to employees who are eligible individuals but are not covered under the employer's HDHP.

Q–2: What is the effective date for the rules in this section?

A–2: The rules in this section are effective for are effective for employer contributions made for calendar years beginning on or after January 1, 2010.

[T.D. 9457, 74 FR 45999, Sept. 8, 2009]

§ 54.4981A–1T Tax on excess distributions and excess accumulations (temporary).

The following questions and answers relate to the tax on excess distributions and excess accumulations under section 4981A of the Internal Revenue Code of 1986, as added by section 1133 of the Tax Reform Act of 1986 (Pub. L. 99–514) (TRA '86).

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a. General Provisions and Excess Distributions
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a. General Provisions and Excess Distributions

a-1: Q. What changes were made by section 1133 of TRA '86 regarding excise taxes applicable to distributions from qualified employer plans and individual retirement plans?

A. Section 1133 of TRA '86 added section 4981A to the Code. Section 4981A imposes an excise tax of 15 percent on (a) excess distributions, as defined in section 4981A(c)(1) and Q&A a-2 of this section, and (b) excess accumulations, as defined in section 4981A(d)(3) and Q&A d-2 of this section. The excise tax on excess distributions generally applies to excess distributions made after December 31, 1986 (see Q&A c-6 of this section). The excise tax on excess accumulations applies to estates of decedents dying after December 31, 1986 (see Q&A d-11 of this section). Excess distributions are certain distributions from qualified employer plans and individual retirement plans. Excess accumulations are certain amounts held on the date of death of an employee or individual by qualified plans and individual retirement plans.

a-2: Q. How are excess distributions defined?

A. Excess distributions are generally defined as the excess of the aggregate amount of distributions received by or with respect to an individual during a calendar year over the greater of (a) $150,000 (unindexed) or (b) $112,500 (indexed as provided in Q&A a-9 of this section beginning in 1988 for cost-of-living increases). Certain individuals may elect to have the portion of their excess distributions that is subject to tax determined under a ''special grandfather'' rule that is described below (see Q&A b-1 through b-14 of this section).

a-3: Q. Distributions from what plans and arrangements are taken into account in applying section 4981A?

A. (a) *General rule.* Section 4981A applies to distributions under any qualified employer plan or individual retirement plan described in section 4981A(e). For this purpose, a qualified employer plan means any—

(1) Qualified pension, profit-sharing or stock bonus plan described in section 401(a) that includes a trust exempt from tax under section 501(a);

(2) Annuity plan described in section 403(a);

(3) Annuity contract, custodial account, or retirement income account described in section 403(b)(1), 403(b)(7) or 403(b)(9); and

(4) Qualified bond purchase plan described in section 405(a) prior to that section's repeal by section 491(a) of the Tax Reform Act of 1984 (TRA '84).

(b) *Individual retirement plan.* An individual retirement plan is defined in section 7701(a)(37) and means any individual retirement account described in section 408(a) or individual retirement annuity described in section 408(b). Also, an individual retirement plan includes a retirement bond described in section 409(a) prior to that section's repeal by section 491(b) of the Tax Reform Act of 1984 (TRA '84).

(c) *Other distributions.* (1) Distributions under any plan, contract or account that has at any time been treated as a qualified employer plan or individual retirement plan described in paragraph (a) or (b) of this Q&A a–3 will be treated for purposes of section 4981A as distributions from a qualified employer plan or individual retirement plan whether or not such plan, contract, or account satisfies the applicable qualification requirements at the time of the distribution.

(2)(i) For purposes of this paragraph (c), an employer plan will be considered to have been treated as a qualified employer plan if any employer maintaining the plan has at any time filed an income tax return and claimed deductions that would be allowable under section 404 (and that were not disallowed) only if the plan was a qualified employer plan under section 401(a) or 403(a). Similarly, if an income tax return has been filed at any time with respect to the trust (or plan or insurance company), and the income of the trust (insurance company, etc.) is reported (and is not disallowed) based on the trust (or plan) being treated as a qualified employer plan described in section 401(a), or 403 (a) or (b), then the employer plan is considered to have been treated as a qualified employer plan.

(ii) For purposes of this paragraph (c), an individual retirement plan (IRA) will be considered to have been treated as a qualified IRA if any contributions to the IRA were either deducted (or designated as a nondeductible contribution described in section 408(o)) on a filed individual income tax return or excluded from an individual's gross income on a filed income tax return because such contributions were reported as regular contributions or rollover contributions (such as those described in section 402(a)(5), 403(a)(4), 403(b)(8) or 408(d)(3)) to an IRA described in section 408 (a) or (b) (or section 409 of pre-1984 law). Similar treatment applies to an employer contribution to a simplified employee pension described in section 408(k), if such contribution is deducted on an employer's filed income tax return, including a self-employed individual's return.

a–4: Q. Which distributions with respect to an individual under a qualified employer plan or an individual retirement plan are excluded from consideration for purposes of determining an individual's excess distributions?

A. (a) *Exclusions.* In determining the extent to which an individual has excess distributions for a calendar year, the following distributions are disregarded—

(1) Any distribution received by any person with respect to an individual as a result of the death of that individual.

(2) Any distribution with respect to an individual that is received by an alternate payee under a qualified domestic relations order within the meaning of section 414(p) that is includible in the income of the alternate payee.

(3) Any distribution with respect to an individual that is attributable to the individual's investment in the contract as determined under the rules of section 72(f). This would include, for example, distributions that are excluded from gross income under section 72 because they are treated as a recovery of after-tax employee contributions

from a qualified employer plan or nondeductible contributions from an individual retirement plan.

(4) Any portion of a distribution to the extent that it is not included in gross income by reason of a rollover contribution described in section 402(a)(5), 403(a)(4), 403(b)(8), or 408(d)(3).

(5) Any health coverage or any distribution of medical benefits provided under an arrangement described in section 401(h) to the extent that the coverage or distribution is excludible under section 104, 105, or 106.

(b) *Alternate payee*. Any distributions to an alternate payee described in paragraph (a)(2) of this Q&A a–4 must be taken into account by such alternate payee for purposes of calculating the excess distributions received by (or excess accumulations held by) the alternate payee.

a–5: Q. If an annuity contract that represents an irrevocable commitment to provide an employee's benefits under the plan is distributed to an individual, how are the distribution of such annuity contract and distributions of amounts under such a contract taken into account for purposes of calculating excess distributions?

A. Except to the extent that the value of an annuity contract is includible in income in the year the contract is distributed or any subsequent year, the distribution of an annuity contract (including a group annuity contract) in satisfaction of plan liabilities is disregarded for purposes of calculating excess distributions. Any amounts that are actually distributed under the contract to the individual (to the extent not excluded under Q&A a–4 of this section) or are otherwise includible in income with respect to the contract (e.g., by reason of the inclusion in income of the value of the annuity contract in the year of the contract's distribution or any subsequent year) are taken into account for purposes of calculating excess distributions for the calendar year during which such amounts are received or otherwise includible in income. For purposes of this Q&A a–5, the term *plan* means any qualified employer plan or individual retirement plan specified in section 4981A(e) and Q&A a–3 of this section.

a–6: Q. Are minimum distributions required under section 401(a)(9), 408(a)(6), 408(b)(3) or 403(b)(10) taken into account to determine excess distributions?

A. Yes. Distributions received during a calendar year are taken into account in determining an individual's excess distributions for such calendar year even though such distributions are required under section 401(a)(9), 408(a)(6), 408(b)(3) or 403(b)(10). For example, minimum distributions under section 401(a)(9) received during the 1987 calendar year for calendar years 1985 and 1986 will be subject to section 4981A as distributions for 1987.

a–7: Q. Are distributions of excess deferrals permitted under section 402(g)(2), or distributions of excess contributions or excess aggregate contributions permitted under section 401(k) or (m), or distributions of IRA contributions permitted under section 408(d) (4) or (5) taken into account for purposes of calculating excess distributions?

A. No. Distributions of excess deferrals, excess contributions, excess aggregate contributions, distributions of IRA contributions, and income allocable to such contributions or deferrals, that are made in accordance with the provisions of sections 402(g)(2), 401(k)(8), 401(m)(6), or 408(d) (4) or (5) are not taken into account for purposes of calculating excess distributions.

a–8: Q. What distributions from qualified employer plans or individual retirement plans are taken into account in determining an individual's excess distributions?

A. With the exception of distributions noted above in Q&As a–4, a–5, and a–7 of this section, all distributions from qualified employer plans or individual retirement plans must be taken into account in determining an individual's excess distributions for the calendar year in which such distributions are received. In general, all such distributions are taken into account whether or not they are currently includible in income. Thus, for example, net unrealized appreciation in employer securities described in section 402(a) is taken into account in the year distributed. However, health coverage or distributions of medical benefits

provided under an arrangement described in section 401(h) that are excludible from income under section 104, 105, or 106 are not subject to section 4981A. In addition, distributions that are excludible from income because they are rolled over to a plan or an individual retirement account are not taken into account. (See Q&A a–4(a) (4) and (5) of this section). Amounts that are includible in income for a calendar year are treated as distributions and, thus, are taken into account even if the amounts are not actually distributed during such year. Thus, deemed distributions to provide insurance coverage includible in income under section 72 (PS–58 amounts), loan amounts treated as deemed distributions under section 72(p), and amounts includible under section 402(b) or section 403(c) by reason of the employer plan or individual retirement plan not being qualified during the year are taken into account.

a–9: Q. Will the dollar threshold amount used to determine an individual's excess distributions be adjusted for inflation in calendar years after 1987?

A. Beginning in 1988, the $112,500 threshold amount is adjusted to reflect post-1986 cost-of-living increases (COLAs) at the same time and in the same manner as the adjustment described in section 415(d). The threshold amount is adjusted even though the distribution is from a defined contribution plan that is subject to a freeze on COLAs because the defined benefit plan limit is below $120,000 (see section 415(c)(1)(A)). However, the $150,000 threshold amount is not adjusted to reflect such increases.

b. Special Grandfather Rule

b–1: Q. How are benefits accrued before TRA '86 treated under the excise tax provisions described in section 4981A?

A. (a) *Grandfather amount.* Certain eligible individuals may elect to use a special grandfather rule that exempts from the excise tax the portion of distributions treated as a recovery of such individual's total benefits accrued on or before August 1, 1986 (grandfather amount). However, distributions that are treated as a recovery of the grandfather amount are taken into account in determining the extent to which other distributions are excess distributions (see Q&A b–4 of this section). Under this special grandfather rule, the grandfather amount equals the value of an individual's total benefits (as described in Q&As b–8 and b–9 of this section) in all qualified employer plans and individual retirement plans on August 1, 1986. An individual's benefits in such plans include amounts determinable on August 1, 1986, that are payable to the individual under a qualified domestic relations order within the meaning of section 414(p) (QDRO). However, QDRO benefits that, when destributed, are includible in the income of the alternate payee are not included in the employee's grandfathered amount. Further, plan benefits that are attributable to a deceased individual and that are payable to an eligible individual as a beneficiary are generally not included in determining the eligible individual's grandfather amount. Procedures for determining the grandfather amount are described in Q&As b–11 through b–14 of this section.

(b) *Recovery of grandfather amount.* The portion of any distribution made after August 1, 1986, that is treated as a recovery of a grandfather amount depends on which of two grandfather recovery methods the individual elects. The two alternative methods are described in the Q&As b–11 through b–14 of this section. The amount of the distribution for a year that is treated as a recovery of a grandfather amount in a year is applied to reduce the individual's unrecovered grandfather amount for future years (*i.e.*, the individual's accrued benefits as described in Q&As b–8 and b–9 on August 1, 1986, reduced by previous distributions treated as a recovery of a grandfather amount) on a dollar for dollar basis until the individual's unrecovered grandfather amount has been reduced to zero. When the individual's grandfather amount has been reduced to zero, the special grandfather rule ceases to apply and the entire amount of any subsequent excess distributions received is subject to the 15 percent excise tax.

b–2: Q. Who may elect to use the special grandfather rules?

A. Any individual whose accrued benefits as described in Q&As b–8 and b–9 of this section in all qualified plans and individual retirement plans on August 1, 1986 (initial grandfather amount) have a value of at least $562,500 may elect to use the special grandfather rule.

b–3: Q. How does an eligible individual make a valid election to use the special grandfather rule?

A. (a) *Form of election.* An individual who is eligible to use the special grandfather rule must affirmatively elect to use that rule. The election is made on a Form 5329 filed with the individual's income tax return (Form 1040, etc.) for a taxable year beginning after December 31, 1986, and before January 1, 1989 (*i.e.*, the 1987 or 1988 taxable year).

(b) *Information required.* The individual must report the following information on the Form 5329:

(1) The individual's initial grandfather amount.

(2) The grandfather recovery method to be used.

(3) Such other information as is required by the Form 5329.

(c) *Deadline for election.* The deadline for filing such election is the due date, calculated with extensions, for filing the individual's 1988 income tax return. If an individual dies before the expiration of such deadline, an election, or the revocation of a prior election, may be made as part of the final income tax return filed on behalf of such deceased individual by the deceased individual's personal representative. An election or revocation of a prior election may also be filed before the expiration of such deadline with Schedule S (Form 706). See Q&A c–7 of this section.

(d) *Revocation of election.* Elections filed before the deadline may be revoked by filing an amended income tax return for any applicable year. A change in the grandfather recovery method is considered a revocation of a prior election and an amended Form 5329 must be filed for any prior year in which a different grandfather recovery method was used. Thus, a change in the election may require a change in the 1987 tax return. An individual must refile for 1987 based on the new election if additional tax is owed. However, an election (or nonelection) is irrevocable after the filing deadline for the taxable year beginning in 1988 has passed. Thus, an individual who has not made an election by the last day plus extensions for filing the 1988 return may not do so through an amended return.

(e) *Subsequent years.* (1) Any eligible individual who has elected the special grandfather rule must attach to the individual's income tax return for all subsequent taxable years in which the individual receives excess distributions (determined without regard to the grandfather rule) a copy of the Form 5329 on which the individual elected the grandfather rule. A copy of the Form 5329 on which the individual (or the individual's personal representative) elected the grandfather rule must also be filed with Schedule S (Form 706) unless the initial election is filed with such schedule.

(2) The individual must also make such other reports in the form and at the time as the Commissioner may prescribe. See Q&A c–7 of this section for the applicable reporting requirements if the individual or the individual's estate is liable for any tax on excess distributions or on an excess accumulation under section 4981A (a) or (d).

b–4: Q. How individuals who have elected to use the special grandfather rule determine the extent to which their distributions for any calendar year are excess distributions?

A. (a) *Excess distributions under grandfather rule, threshold amount.* Individuals who elect to use the special grandfather rule are not eligible to use the $150,000 threshold amount in computing their excess distributions for any calendar year. Instead, such electing individuals must compute their excess distributions for a calendar year using a $112,500 (indexed for cost-of-living increases) threshold amount. The rule of this paragraph (a) applies for all calendar years, including the calendar year in which an individual's unrecovered grandfather amount has been reduced to zero and all subsequent calendar years. Once the indexed amount has increased to $150,000 or more, the threshold amount will be the same for all individuals.

(b) *Base for excise tax under grandfather rule.* Although the portion of any

distribution that is treated as a recovery of an individual's grandfather amount is not subject to the excise tax, such portion must be taken into account in determining the extent to which the individual has excess distributions for a calendar year. The effect of this rule is that the amount against which the 15 percent excise tax is applied for any calendar year during which a grandfather amount is recovered equals the individual's distributions for such year reduced by the greater of (1) the applicable threshold amount for such year or (2) the grandfather amount recovered for such year. (See the examples in Q&A b–14 of this section.)

b–5: Q. How is the value of an individual's total accrued benefits on August 1, 1986, calculated for purposes of determining (a) whether an individual is eligible to elect the special grandfather rule and (b) the amount of any electing individual's initial grandfather amount under such rule?

A. (a) *Introduction.* The value of an individual's total accrued benefits on August 1, 1986, is the sum of the values of the individual's accrued benefits on such date under all qualified employer plans or individual retirement plans, as determined under the Q&A b–5. If such value exceeds $562,500, the individual may elect the special grandfather rule. In such case, the value so determined may be applied against distributions as determined under this section, whether or not such distributions are from the same plan or IRA for which such grandfather amount is determined. For purposes of determining the value of accrued benefits on August 1, 1986, an annuity contract or an individual's interest in a group annuity contract described in Q&A a–5 of this section is treated as an accrued benefit under the qualified retirement plan or IRA from which it was distributed and an IRA is treated as a defined contribution plan.

(b) *Defined benefit plan*—(1) *General rule.* The amount of an individual's accrued benefit on August 1, 1986, under a defined benefit plan is determined as of that date under the provisions of the plan based on the individual's service and compensation on that date. The present value of such benefit is determined by an actuarial valuation of such accrued benefit performed as of August 1, 1986. Alternatively, accrued benefits may be determined as of July 31, 1986. In such case, the applicable rules are applied by substituting the July 31 date for the August 1 date in the applicable provisions. (See Q&A b–9 of this section for rules for determining the amount of benefits and values and the actuarial assumptions to be used in such determination.)

(2) *Alternative method.* Alternatively, the present value of an individual's accrued benefit on August 1, 1986, may be determined using the following method:

(i) Determine the amount of the individual's actual accrued benefit (prior benefit) on the valuation date that immediately precedes August 1, 1986 (prior date). The valuation date for purposes of using this alternative method is the valuation date used for purposes of section 412. In making this determination, plan amendments that are adopted after that prior date are disregarded.

(ii) Determine the amount of the individual's adjusted accrued benefit (adjusted prior benefit) on the prior date by reducing the prior benefit in paragraph (b)(2)(i) of this Q&A b–5 by the amount of distributions that reduce the accrued benefit or transfers from the plan and by increasing the prior benefit in paragraph (b)(2)(i) of this Q&A b–5 by any increase in benefit resulting from either transfers to the plan or plan amendments that were made (or, in the case of a plan amendment, both adopted and effective) after the prior valuation date, but on or before August 1, 1986.

(iii) Determine the amount of the individual's actual accrued benefit (future benefit) on the valuation date immediately following August 1, 1986 (next date). In making this determination, plan amendments, etc. that are either adopted or effective after August 1 are disregarded.

(iv) Determine the amount of the individual's adjusted accrued benefit (adjusted future benefit) on the next date by increasing the future benefit in paragraph (b)(2)(iii) of this Q&A b–5 by the amount of any distributions that reduce the accrued benefit or transfers

from the plan and by reducing the future benefit in paragraph (b)(2)(iii) of this Q&A b–5 by the amount of any transfer to the plan that was made after August 1, 1986, but on or before the next valuation date to the amount in paragraph (b)(2)(iii) of this Q&A b–5.

(v) Calculate the weighted average of paragraphs (b)(2)(ii) and (b)(2)(iv) of this Q&A b–5, where the weights applied are the number of complete calendar months separating the applicable prior date and the applicable next date, respectively, and August 1, 1986.

(vi) Determine the actuarial present value of the benefit in paragraph (b)(2)(v) of this Q&A b–5 as of August 1, 1986, using the methods and assumptions described in Q&A b–9 of this section.

The grandfather amount on August 1, 1986, attributable to the accrued benefits under the defined benefit plan is equal to the amount determined in paragraph (b)(2)(vi) of this Q&A b–5.

(3) *Certain insurance plans treated as defined contribution plans.* (i) Accrued benefits not in pay status under a plan satisfying the requirements of section 411(b)(1)(F) are determined under the rules in paragraph (c) of this Q&A b–5 for defined contribution plans. For purposes of applying paragraph (c) of this Q&A b–5 to such benefits, the cash surrender value of the contract is substituted for the account balance. If accrued benefits are in pay status under such a plan, the rules of this paragraph (b) apply to such benefits.

(ii) Accrued benefits not in pay status that are attributable to voluntary employee contributions (including rollover amounts) to a defined benefit plan are determined under the rules in paragraph (c) of this Q&A b–5 as if the account balance attributable thereto is under a defined contribution plan. If such benefits are in pay status and are used to fund the benefit under the defined plan, the rules of this paragraph (b) apply to such benefits.

(c) *Defined contribution plan*—(1) *General rule.* The value of an individual's accrued benefit on August 1, 1986, under a defined contribution plan (including IRAs) is the value of the individual's account balance on such date (or on the immediately preceding day). Paragraph (b)(3) of this Q&A b–5 requires that benefits derived from certain insured plans and from voluntary contributions to a defined benefit plan be determined under the rules of this paragraph (c).

(2) *Alternative method.* Alternatively, if a valuation was not performed as of August 1, 1986 (or as of the immediately preceding day), the value of an individual's accrued benefit may be determined as follows:

(i) Determine the value of the individual's account balance on the valuation date immediately preceding August 1, 1986 (prior valuation date).

(ii) Determine the value of the individual's adjusted account balance on the prior valuation date by subtracting (or adding, respectively) the amount of any distribution, including a transfer to another plan or a forfeiture from the account balance (or the amount of any allocation to the account balance, including a transfer from another plan, rollover received or forfeiture from another account) that was made after the prior valuation date but on or before August 1, 1986, from (or to) the amount in paragraph (c)(2)(i) of this Q&A b–5.

(iii) Determine the value of the individual's account balance on the valuation date immediately following August 1, 1986 (next valuation date).

(iv) Determine the value of the individual's adjusted account balance on the next valuation date by adding (or subtracting, respectively) the amount of any distribution, of a type described in paragraph (c)(2)(ii) of this Q&A b–5 (or the amount of any allocation to the account balance, of a type described in paragraph (c)(2)(ii) of this Q&A b–5), that was made after August 1, 1986, but on or before the next valuation date to (or from) the amount in paragraph (c)(2)(iii) of this Q&A b–5.

(v) Calculate the weighted average of paragraphs (c)(2)(ii) and (c)(2)(iv) of this Q&A b–5, where the weights applied are the number of complete calendar months separating the applicable valuation date and the applicable next date, respectively, and August 1, 1986.

The grandfather amount on August 1, 1986, attributable to the account balance in the defined contribution plan or the individual retirement plan is the amount in paragraph (c)(2)(v) of this Q&A b–5.

b–6: Q. For purposes of determining the value of accrued benefits in a defined contribution plan or a defined benefit plan on August 1, 1986, are nonvested benefits taken into account?

A. Yes. All accrued benefits, whether or not vested, are taken into account.

b–7: Q. To what extent are benefits payable with respect to an individual under a qualified employer plan or an individual retirement plan not taken into account for purposes of calculating the individual's grandfather amount?

A. (a) *Exclusions.* The following benefits payable with respect to an individual are not taken into account for purposes of this calculation:

(1) Benefits attributable to investment in the contract as defined in section 72(f). However, amounts attributable to deductible employee contributions (as defined in section 72(o)(5)(A)) are considered part of the accrued benefit.

(2) Amounts that are determinable on August 1, 1986, as payable to an alternate payee who is required to include such amounts in gross income (a spouse or former spouse) under a qualified domestic relations order (QDRO) within the meaning of section 414(p).

(3) Amounts that are attributable to IRA contributions that are distributed pursuant to section 408(d) (4) or (5).

(b) *Alternate payee.* Under a QDRO described in paragraph (a)(2) of this Q&A b–7, amounts are considered part of the accrued benefit of the alternate payee for purposes of calculating the value of the alternate payee's accrued benefit on August 1, 1986. Similarly, such amounts are used by the alternate payee to compute excess distributions.

b–8: Q. What adjustments to the grandfather amount are necessary to take into account rollovers from one qualified employer plan or individual retirement plan to another such plan?

A. (a) *Rollovers outstanding on valuation date.* Generally, rollovers between plans result in adjustment to the grandfather amounts under the rules in Q&A b–5 of this section. However, if a rollover amount is distributed from one plan on or before an applicable valuation date of such plan and is rolled over into the receiving plan after the receiving plan's applicable valuation date and if these events result in an inappropriate duplication or omission of the rollover amount, then an adjustment to the grandfather amount must be made to remove the duplication or omission. The Commissioner may provide necessary rules concerning this adjustment.

(b) *Valuation.* If the rollover amount described in paragraph (a) of this Q&A b–8 is in a form of property other than cash, the property of which the outstanding rollover consists is valued as of the date the rollover contribution is received by the transferee qualified employer plan or individual retirement plan and that value is the amount of the rollover. If the outstanding rollover is in the form of cash, the amount of the cash is the amount of the rollover.

b–9: Q. What is the form of the grandfather benefit under a defined benefit plan and how is it valued?

A. (a) *Benefit form.* The grandfather amount under a defined benefit plan is determined on the basis of the form of benefit (including any subsidized form of benefit such as a subsidized early retirement benefit or a subsidized joint and survivor annuity) provided under the plan as of August 1, 1986 that has the greatest present value as determined in paragraph (b) of this b–9. If the plan provides a subsidized joint and survivor annuity, for purposes of determining the grandfather amount, it will be assumed that an unmarried individual is married and that the individual spouse is the same age as the individual. Assumptions as to future withdrawals, future salary increases or future cost-of-living increases are not permitted.

(b) *Value of grandfather amount.* The grandfather amount under a defined benefit plan is the present value of the individual's benefit form determined under paragraph (a) of this Q&A b–9. Thus, the benefit form is reduced to reflect its value on the applicable valuation date. The present value of the benefit form on August 1, 1986, or the applicable date, is computed using the factors specified under the terms of the plan as in effect on August 1, 1986, to calculate a single sum distribution if the plan provides for such a distribution. If the plan does not provide for

such a distribution form, such present value is computed using the interest rate and mortality assumptions specified in § 20.2031–7 of the Estate Tax Regulations.

b–10: Q. Is the plan administrator (or trustee) of a qualified plan (or individual retirement account) required to report to an individual the value of the individual's benefit under the plan as of August 1, 1986?

A. (a) *Request required.* No report is required unless the individual requests a report and the request is received before April 15, 1989. If requested, the plan administrator (or trustee or issuer) must report to such individual the value of the individual's benefit under the plan as of August 1, 1986, determined in accordance with Q&A b–5 through b–9 of this section. Such report must be made within a reasonable time after the individual's request but not later than July 15, 1989.

(b) *Other rules.* Alternate payees must make their own request for valuation reports. Any report furnished to an employee who has an alternate payee with respect to the plan must include the separate values attributable to each such individual. Any report furnished to an alternate payee must include only the value attributable to the alternate payee. Reports may be furnished to individuals even if no request is made. Individuals must keep records of the reports received from plans or IRAs in order to substantiate all grandfather amounts.

(c) *Authority.* The rules in this Q&A are provided under the authority in section 6047(d).

b–11: Q. How is the portion of a distribution that is treated as a recovery of an individual's grandfather amount as described in b–1 of this section to be calculated?

A. (a) *General rule.* All distributions received between August 1 and December 31, 1986, inclusive, are treated as a recovery of a grandfather amount. The portion of distributions received after December 31, 1986, that is treated as a recovery of the grandfather amount is determined under either the discretionary method or the attained age method. An amount that is treated as a recovery of grandfather benefits is applied to reduce the initial grandfather amount that was calculated as of August 1, 1986, on a dollar for dollar basis until the unrecovered amount has been reduced to zero. No other recalculation of the grandfather amount is to be made for a date after August 1, 1986.

(b) *Methods, etc.* The grandfather amount may be recovered by an individual under either the discretionary method or the attained age method. After the individual's total grandfather amount is treated as recovered under either method, the tax on excess distributions and excess accumulations is determined without regard to any grandfather amount.

b–12: Q. Under the discretionary method, what portion of each distribution is treated as a return of the individual's grandfather amount?

A. (a) *Initial percentage.* Under the discretionary method, unless the individual elects in accordance with paragraph (b) below, 10 percent of the total distributions that the individual receives during any calendar year is treated as a recovery of the grandfather amount.

(b) *Acceleration.* The individual may elect to accelerate the rate of recovery to 100 percent of the total aggregate distributions received during a calendar year commencing with any calendar year, including 1987 (acceleration election). In such case, the rate of recovery is accelerated to 100 percent for the calendar year with respect to which the election is made and for all subsequent calendar years.

(c) *Election.* To recover the grandfather amount using the discretionary method, an individual must elect to use such method when making the election to use the special grandfather rule on the Form 5329. (See Q&A b–3 of this section.) The acceleration election must be made for the individual's taxable year beginning with or within the first calendar year for which such election is made and must be filed with the individual's income tax return for that year. Such acceleration election may also be made or revoked retroactively on an amended return for such year. However, the acceleration election may not be made after the individual's death other than with the individual's final income tax return or with a return for a prior year for which a return

was not filed before the individual's death. Thus, the acceleration election may not be made on an amended return filed after the individual's death for a year for which a return was filed before the individual's death. The preceding two sentences shall not apply to deaths occurring in 1987 or 1988. The estate is entitled to use the remaining grandfather amount to determine if there is an excess accumulation. See Q&A d–3 of this section. The acceleration election shall be made on such form and in such manner as the Commissioner prescribes in a manner consistent with the rules of this section.

b–13: Q. Under the attained age method, what portion of each distribution is treated as a return of the individual's grandfather amount?

A. Under the attained age method, the portion of total distributions received during any year that is treated as a recovery of an individual's grandfather amount is calculated by multiplying the individual's aggregate distributions for a calendar year by a fraction. The numerator of the fraction is the difference between the individual's attained age in completed months on August 1, 1986, and the individual's attained age in months at age 35 (420 months). The denominator of the fraction is the difference between the individual's attained age in completed months on December 31 of the calendar year and the individual's attained age in months at age 35 (420 months). An individual whose 35th birthday is after August 1, 1986, may not use the attained age method.

b–14: Q. How is the 15 percent tax with respect to excess distributions for a calendar year calculated by an individual who has elected to use the special grandfather rule?

A. The calculation of the excise tax may be illustrated by the following examples:

Example 1. (a) An individual (A) who participates in two retirement plans, a qualified defined contribution plan and a qualified defined benefit plan, has a total value of accrued benefits on August 1, 1986 under both plans of $1,000,000. Because this amount exceeds $562,500, A is eligible to elect to use the special grandfather rule to calculate the portion of subsequent distributions that are exempt from tax. A elects to use the discretionary grandfather recovery method and attaches a valid election to the 1987 income tax return. A does not elect to accelerate the rate of recovery for 1987. On October 1, 1986, A receives a distribution of $200,000. On February 1, 1987, A receives a distribution of $45,000 and, on November 1, 1987, receives a distribution of $200,000. The 15 percent excise tax applicable to aggregate distributions in 1987 is calculated as follows:

(1) Value of grandfather amount on 8/1/86 ..... $1,000,000
(2) Grandfather amounts recovered in 1986 but after 8/1/86 ..... $200,000
(3) Value of grandfather amount on 12/31/86 ((1) – (2)) $800,000
(4) Grandfather recovery percentage 10%
(5) Distributions between 1/1/87 and 12/31/87 ($45,000×$200,000) $245,000
(6) Portion of (5) exempt from tax ((4)×(5)) $24,500
(7) Amount potentially subject to tax ((5) – (6)) $220,500
(8) Portion of aggregate distributions in excess of $112,500 ($45,000×$200,000 – $112,500) $132,500
(9) Amount subject to tax (lesser of (7) and (8)) $132,500
(10) Amount of tax (15% of (9)) $19,875
(11) Remaining undistributed value of grandfather amount as of 12/31/87 ((3) – (6)) $775,500

(b) In 1988, A receives no distributions from either plan. On February 1, 1989, A receives a distribution of $300,000 and on December 31, 1989, receives a distribution of $75,000. A makes a valid acceleration election for the 1989 taxable year, whereby A accelerates the rate of grandfather recovery that will apply for calendar years after 1988 to 100 percent. Assume the annual threshold amount for the 1989 calendar year is $125,000 (*i.e.*, 112,500 indexed). The 15 percent excess tax applicable to distributions in 1989 is calculated as follows:

(1) Value of grandfather amount on 8/1/86 ..... $775,500
(2) Grandfather recovery percentage designated for 1989 calendar year 100%
(3) Distributions between 1/1/89 and 12/31/89 ($300,000×$75,000) $375,000
(4) Portion of (3) exempt from tax (2)x(3) $375,000
(5) Amount potentially subject to tax ((3) – (4)) $0
(6) Portion of aggregate distributions in excess of $125,000 ($300,000×$75,000 – $125,000) $250,000
(7) Amount subject to tax (lesser of (5) and (6)) $0
(8) Amount of tax (15% of (7)) $0
(9) Remaining undistributed value of grandfather amount as of 12/31/89 ((1) – (4)) $400,500

The entire amount of any distribution for subsequent calendar years will be treated as a recovery of the grandfather amount and applied against the grandfather amount until the unrecovered grandfather amount is reduced to zero.

Example 2. The facts are the same as in *Example 1* except that A elects to use the attained age recovery method and A makes a valid election for the 1987 taxable year. Further assume that A's attained age in months on August 1, 1986 is 471 months and on December 31, 1987, is 488 months. The 15 percent excise tax applicable to aggregate distributions in 1987 is calculated as follows:

(1) Value of grandfather amount on 8/1/86 ..... $1,000,000
(2) Grandfather amounts recovered in 1986 but after 8/1/86 ..... $200,000
(3) Value of grandfather amount on 12/31/86 ((1) − (2)) $800,000
(4) Completed months of age in excess of 420 on 8/1/86 51
(5) Completed months of age in excess of 420 on 12/31/87 68
(6) Grandfather fraction as of 12/31/86 ((4) divided by (5)) ..... ¾
(7) Distributions between 1/1/87 and 12/31/87 ($45,000 + $200,000) $245,000
(8) Portion of (7) exempt from tax ((6)×(7)) $183,750
(9) Amount potentially subject to tax ((7) − (8)) $61,250
(10) Portion of aggregate distributions in excess of $112,500 ($45,000 + $200,000 − $112,500) $132,500
(11) Amount subject to tax (lesser of (9) and (10)) $61,250
(12) Amount of tax (15% of (11) $9,187
(13) Unrecovered grandfather amount as of 12/31/87 ((3) − (8)) $616,250

c. Special Rules

c-1: Q. How is the excise tax computed if a person elects special tax treatment under section 402 or 403 for a lump sum distribution?

A. (a) *General rule*—(1) *Conditions.* Section 4981A(c)(4) provides for a special tax computation that applies to an individual in a calendar year if the individual receives distributions that include a lump sum distribution and the individual makes certain elections under section 402 or 403 with respect to that lump sum distribution (lump sum election).

(2) *Lump sum election.* A lump sum election includes an election of (i) 5-year income averaging under section 402(e)(4)(B); (ii) phaseout capital gains treatment under sections 402(a)(2) or 403(a)(2) prior to their repeal by section 1122(b) of TRA '86 and as permitted under section 1122(h)(4) of TRA '86; (iii) grandfathered long-term capital gains under sections 402(a)(2) and 403(a) prior to such repeal and as permitted by section 1122(h)(3) of TRA '86; and (iv) grandfathered 10-year income averaging under section 402(e) (including such treatment under a section 402(e)(4)(L) election) prior to amendment by section 1122(a) of TRA '86 and as permitted by section 1122(h)(3)(A)(ii) and (5) of the TRA '86.

(3) *Special tax computation.* (i) If the conditions in paragraph (a)(1) of this Q&A c-1 are satisfied for a calendar year, the rules of this subparagraph (a)(3) apply for purposes of determining whether there are excess distributions and tax under section 4981A.

(ii) All distributions are divided into two categories. These two categories are the lump sum distribution and other distributions. Whether or not a particular distribution is a distribution subject to section 4981A and is in either category is determined under the rules in section 4981A and this section. Thus, the exclusions under section 4981A(c)(2) and Q&A a-4(a) of this section apply here. For example, a distribution that is a tax-free recovery of employee contributions is not in either category.

(iii) The excise tax under section 4981A(c)(1) is computed in the normal manner except that (A) it is the sum of the otherwise applicable taxes determined separately for the two categories of excess distributions and (B) a different amount (threshold amount) is subtracted from the distributions in each category in determining the amount of the excess distributions. The threshold amount that is subtracted from the portion of the distributions that is not part of the lump sum distribution is the applicable threshold amount, determined without regard to section 4981A(c)(4) and the lump sum election. Thus, the threshold amount subtracted from the amount in this category is either the $150,000 amount or the $112,500 amount (indexed). The threshold amount that is subtracted from the amount of the lump sum distribution is 5 times the applicable threshold amount as described above. Thus, the threshold amount subtracted from the lump sum distribution is

$750,000 or 5 times $112,500 indexed (initially $562,500).

(b) *Grandfather rule*—(1) *In general.* This paragraph (b) provides special rules where an individual makes both the grandfather election described in section 4981A(c)(5) and the lump sum election described in paragraph (a) of this Q&A c-1. See Q&A b-11 through 14 for other rules that apply to such grandfather election.

(2) *Discretionary method.* If the individual uses the discretionary method, described in Q&As b-11 and 12 of this section, the applicable threshold amount is $112,500 (indexed). Under this method, the grandfather amount is recovered at a 10 percent or 100 percent rate in any calendar year and is offset separately against distributions in each category of distributions at the appropriate rate. If, for any calendar year, distributions are received in both categories and the total of the appropriate percentage (10 percent or 100 percent) of the distributions in each category exceed the unrecovered grandfathered account, then such grandfather amount must be recovered ratably from the distributions in each category. This rule applies even if the distributions in one category are less than the threshold amount for that category and the distributions in the other category exceed the threshold amount for that category.

(3) *Attained age method.* If the individual uses the attained age method, described in Q&As b-11 and 13 of this section, the threshold amount is $112,500 (indexed). Under this method, to determine the portion of the distributions in each category that is treated as a recovery of the grandfather amount, the fraction described in Q&A b-13 of this section is applied separately to the distributions in each category of distributions. If, for any calendar year, distributions are received in both categories and the total of the amounts of the distributions in each category that are treated as a recovery of the grandfather amount exceeds that undercovered grandfather amount, then such grandfather amount must be recovered ratably from the distributions in each category. This rule applies even if the distributions in one category are less than the threshold amount for that category and the distributions in the other category exceed the threshold amount for that category.

(c) *Amount in lump sum category.* All amounts received from the employer that are required to be distributed to the individual in order to make a lump sum election described in paragraph (a) of this Q&A c-1 are included in the lump sum category. Amounts are in the lump sum category even though they are not subject to income tax under the election. Thus, for example, the following amounts would be in the lump sum category: (1) Appreciation on employer securities received as part of a distribution for which a lump sum treatment is elected; and (2) amounts that are phased out when section 1122 of TRA '86 is elected. However, accumulated deductible employee contributions under the plan (within the meaning of section 72(o)(5)) are in the nonlump sum category.

(d) *Examples.* The rules in this Q&A c–1 are illustrated by the following examples:

Example 1. (a) On January 1, 199X, individual A who is age 65 and is a calendar year taxpayer receives a lump sum distribution described in section 402(e)(4)(A) from a qualified employer plan (Plan X). A receives no other distribution in 199X. A elects 5-year income averaging under section 402(e)(4)(B) and also elects section 402(e)(4)(L) treatment (treating pre-74 participation as post-1973 participation) on A's income tax return for 199X. Thus, A also makes the lump sum election described in paragraph (a)(2), above. For 199X, the $112,500 threshold amount indexed is $125,000. A does not make a grandfather election so that A's threshold amount is $150,000.

(b) A's distribution from Plan X consists of cash in the amount of $800,000. A has a section 72(f) investment in the contract. A has over the years made after tax contributions to Plan X of $50,000. A's distributions subject to section 4981A equal $750,000 because of the exclusion of A's $50,000 after-tax contributions.

(c) A's distributions consist solely of amounts in the lump sum category. A's threshold amount equals $750,000 under the rules of this paragraph (a)(iii), above, (5 times $150,000). Because A's threshold amount ($750,000) equals the amount of A's distribution from Plan X ($750,000) no part of A's distribution from Plan X is treated as an excess distribution subject to the 15-percent excise tax.

Example 2. (a) Assume the same facts as in *Example (1),* except that A receives an additional distribution from an individual retirement plan described in section 408(a) (IRA Y) in 199X of $150,000. A has made no nondeductible contributions to IRA Y and all of the $150,000 is a distribution subject to section 4981A.

(b) A's distributions consist of two categories, the lump sum category (Plan X $750,000) and the other than lump sum category (IRA Y $150,000). A separate threshold amount is subtracted from A's IRA Y distribution. This threshold amount equals $150,000 under the rules of this paragraph (a)(3), above, the same initial threshold amount that is applied against the lump sum prior to the multiplication by 5). Because A's threshold amount ($150,000) equals the amount of A's distribution from IRA Y ($150,000), no part of A's distribution from IRA Y would be treated as an excess distribution subject to the 15-percent excise tax.

Example 3. (a) Assume the same facts as in *Example (2),* except that A's distribution is $825,000 from Plan X, before reduction of $50,000 for employee contributions, instead of $800,000, so that A's distribution subject to section 4981A from Plan X is $775,000. A made a valid grandfather election. Therefore, the applicable threshold amount is $125,000 ($112,500 indexed for 199X). A's unrecovered grandfather amount as of the end of the year preceding 199X is $1,000,000 (A had a benefit under another retirement plan (Plan Z) on August 1, 1986, and A's account balance under Plan Z, which is a stock bonus plan, is $6,000,000 on January 1, 199X.) A also made a valid election of the discretionary method to recover A's grandfather amount.

(b) If A recovers A's grandfather amount in 199X at the 10 percent rate, 10 percent of A's distributions that are in the lump sum category (Plan X $775,000) is treated as a recovery of A's grandfather amount. Similarly, 10 percent of A's distributions that are in the other than lump sum category (IRA Y $150,000) is treated as a recovery of A's grandfather amount. Thus, A's grandfather amount is reduced by $92,500 ($77,500 Plan X and $15,000 IRA Y) for the 199X calendar year and is $907,500 on January 1 of the year following 199X. Because the amounts of the distributions in each category that are treated as a recovery of grandfather amount are less than the applicable threshold amount for each category ($625,000 Plan X, $125,000 IRA Y), the recovery of the grandfather amount does not affect the calculations of the 199X excise tax.

(c) Because A's distribution from IRA Y of $150,000 exceeds A's threshold amount of $125,000 ($112,500 indexed) applicable to nonlump sum distributions by $25,000 and A's distribution subject to section 4981A from Plan X of $775,000 exceeds A's threshold amount of $625,000 (5X$125,000) applicable to lump sums by $150,000, A is subject to the 15-percent excise tax. A's tax under section 4981A is $26,250 (15 percent of $25,000 plus 15 percent of $150,000).

Example 4. (a) Assume the same facts as in *Example (3)* except that A makes a valid acceleration election under the discretionary method with respect to A's grandfather amount of $1,000,000 for calendar year 199X.

(b) Because A's grandfather amount on January 1, 199X ($1,000,000) equals or exceeds A's distribution subject to section 4981A ($925,000) for 199X, no part of A's distribution from Plan X or IRA Y would be treated as excess distribution subject to the 15-percent excise tax.

(c) A's distributions subject to 4981A from Plan X of $775,000 and from IRA Y of $150,000 are offset 100 percent by A's grandfather amount of $1,000,000. Therefore, A's grandfather amount on January 1 of the year following 199X is $75,000 ($1,000,000 minus $925,000). This $75,000 would be required to be offset 100 percent against any distributions received in that year.

Example 5. (a) Assume the same facts as in *Example (4),* except that A's distribution subject to section 4981A from Plan X, after reduction of the $50,000 for employee contributions, is $1,000,000 and from IRA Y is $125,000 (equal to the threshold amount), totaling $1,125,000.

(b) Because the sum of the amount received in the lump sum category and the other than lump sum category of distributions is greater than the grandfather amount ($1,000,000), the grandfather amount must be allocated to each separate category on the basis of the ratio of the amount received in each category to the sum of these amounts. Thus, $888,889 ($1,000,000 X ($1,000,000 divided by $1,125,000)) is allocated to the lump-sum category and $111,111 ($1,000,000 X ($125,000 divided by $1,125,000)) is allocated to the other than lump sum category. A's distributions of $1,000,000 in the lump sum category are reduced by $888,889, the greater of $625,000 (the threshold amount) or $888,889 (grandfather amount), and equal $111,111. A's excise tax is $16,666 (15 percent of $111,111). A owes no excess distribution tax on the $125,000 received from IRA Y because it is fully offset by the threshold amount of $125,000.

(c) Because A's distribution subject to section 4981A for the year of $1,125,000 ($1,000,000 plus $125,000) exceeds A's grandfather amount on January 1, 199X of $1,000,000, A's grandfather amount is zero for all subsequent calendar years.

c–2: Q. Must retirement plans be amended to limit future benefits accruals so that the amounts that are distributed would not be subject to an excise tax under section 4981A?

A. No. A qualified employer plan need not be amended to reduce future benefits so that the amount of annual aggregate distributions are not subject to tax under section 4981A. Section 415 does, however, require plan provisions that limit the accrual of benefits and contributions to specified amounts. The operation of the excise tax of section 4981A is independent of plan qualification requirements limiting benefits and contributions under qualified plans.

c–3: Q. Is a plan amendment reducing accrued benefits a permitted method of avoiding the excise tax?

A. No. Accrued benefits may not be reduced to avoid the imposition of the excise tax. Such reduction would violate employer plan qualification requirements, including section 411(d)(6).

c–4: Q. To what extent is the 15 percent section 4981A tax reduced by the 10 percent section 72(t) tax?

A. (a) *General rule.* The 15 percent tax on excess distributions may be offset by the 10 percent tax on early distributions to the extent that the 10 percent tax is applied to excess distributions. For example, assume that individual (A), age 56, receives a distribution of $200,000 from a qualified employer plan (Plan X) during calendar year 1987. Further, assume that the entire distribution is subject to the 10-percent tax of section 72(t). A tax of $20,000 (10% of $200,000) is imposed on the distribution under section 72(t). Assuming that the distribution is not a lump sum distribution eligible for special tax treatment under section 402, part of the distribution is subject to tax under section 4981A. If A does not elect the special grandfather rule, A's dollar limitation is $150,000 and the amount of $200,000 distribution that is an excess distribution is $50,000 ($200,000–$150,000). The 15 percent tax is $7,500 (15% of $50,000). The portion of the $20,000 section 72(t) tax on early distributions that is attributable to the excess distribution is $5,000 (10% of $50,000). This amount is credited against the section 4981A tax. Therefore, the total tax imposed on the distribution under both provisions is $22,500 ($20,000 + ($7,500–$5,000)).

(b) *Example.* (1) If some, but not all, distributions made for a calendar year are subject to the section 72(t) tax, the offset is applied only to the extent that the section 72(t) tax applies to amounts that exceed the applicable threshold amount for that calendar year. For example, assume that during 1987 individual B receives a distribution of $40,000 that is not subject to the 10 percent section 72(t) tax and a separate distribution of $160,000 that is subject to the 10 percent section 72(t) tax. A tax of $16,000 (10% of $160,000) is imposed by section 72(t). Excess distributions for the year, assuming B does not elect the special grandfather rule, are $50,000 ($40,000 + $160,000–$150,000). The tax under section 4981A is $7,500 (15% of $50,000). For purposes of determining the extent to which the 10 percent tax is applied to excess distributions, the only amounts subject to the 10 percent tax that are taken into account are distributions in excess of $150,000 (or if greater, the $112,500 (indexed) threshold for the year). The amount of distributions for 1987 to which the 10 percent tax is applicable ($160,000) exceeds $150,000 by $10,000. Thus, the portion of the section 72(t) tax of $16,000 that is attributable to excess distributions equals $1,000 (10 percent of $10,000). This amount is credited against the section 4981A tax. The total tax payable under the provisions of sections 72(t) and 4981A is $22,500 ($16,000 + ($7,500–$1,000)).

(c) *Net unrealized appreciation.* A distribution consisting of net unrealized appreciation of employer securities that is excluded from gross income is not subject to section 72(t) and, therefore, there is no section 72(t) tax on such distribution that may be used to offset the tax on excess distributions.

c–5: Q. If a distribution that is subject to both the 10 percent tax on early distributions from qualified plans imposed under section 72(t) and the 15 percent tax on excess distributions imposed under section 4981A is received by an individual who elects to calculate the 15 percent tax using the special grandfather rule, how is the offset of the 10 percent tax imposed under section 72(t) calculated?

A. The section 4981A tax is reduced only by the amount of the 10 percent tax that is attributable to the portion of the distribution to which the section 4981A tax applies. For example, assume

that (a) an individual (A), age 57, receives during 199X a distribution from a qualified plan of $325,000 that is subject to the 10 percent section 72(t) tax; (b) the distribution is not a lump sum distribution and is subject to the 15 percent excise tax imposed by section 4981A; (c) A has elected to use the special grandfather rule; and (d) A accelerates the rate of recovery of the remaining grandfather amount of $250,000 so that only $75,000 of this distribution is subject to the section 4981A tax. Thus, the section 4981A tax is $11,250 (15% of $75,000). The portion of the section 72(t) 10 percent tax that is offset against the section 4981A tax of $11,250 is limited to $7,500 (10% of $75,000), the section 72(t) tax on the amount of distributions after taking into account the reduction under the grandfather rule.

c–6: Q. When do distributions become subject to the excise tax under section 4981A?

A. (a) *General rule*. Excess distributions made after December 31, 1986, are subject to the excise tax under section 4981A.

(b) *Transitional rule*—(1) *Termination*. Distributions prior to January 1, 1988, made on account of certain terminations of a qualified employer plan are not subject to tax under section 4981A. For a plan termination to be eligible for this transitional rule, the plan termination must occur before January 1, 1987. For purposes of applying the rules of section 4981A (except the reporting requirements), any such distribution is treated as if made on December 31, 1986. The distribution of an annuity contract is not an excepted distribution. See Q&A a–5 of this section.

(2) *Lump sum distributions*. A lump sum distribution that an individual who separates from service in 1986 receives in calendar year 1987 before March 16 is treated as a distribution received in 1986 if such individual elects to treat it as received in 1986 under the provisions of section 1124 of TRA '86. Thus, such a qualifying section 1124 distribution is not subject to tax under section 4981A for 1987. For purposes of applying the rules of section 4981A, the amount attributable to such distribution is included in the individual's August 1, 1986 accrued benefit and such distribution is treated as if made on December 31, 1986.

(3) *Grandfather amount recovery*. If an individual described in this paragraph elects the special grandfather rule, the entire amount of distributions described in subparagraph (1) or (2) of this paragraph (b) is treated as a recovery of the individual's grandfather amount because it is treated as received on December 31, 1986. Thus, the individual's outstanding grandfather amount as of the date of the distribution is reduced by the amount of such distribution.

c–7: Q. How is the tax on excess distributions or on excess accumulations under section 4981A reported?

A. (a) *Tax on excess distributions*. An individual liable for tax on account on excess distributions under section 4981A must complete Form 5329 and attach it to his income tax return for the taxable year beginning with or within the calendar year during which the excess distributions are received. The amount of the tax is reported on such form and in such manner as prescribed by the Commissioner.

(b) *Tax on excess accumulations*—(1) *General rule*. If, with respect to the estate of any individual, there is a tax under section 4981A(d) on account of the individual's excess accumulations, the amount of such tax is reported on Schedule S (Form 706 or 706NR). Schedule S must be filed on or before the due date under section 6075 including extensions, for filing the estate tax return. The tax under section 4981A(d) must be paid by the otherwise applicable due date for paying the estate tax imposed by chapter 11 even if, pursuant to section 6018(a), no return is otherwise required with respect to the estate tax imposed by chapter 11.

(2) *Earliest due date*. Notwithstanding paragraph (b)(1) of this c–7, the due date for filing Schedule S (Form 706) and paying the tax on excess accumulations under section 4981A(d) is not earlier than February 1, 1988. Thus, with respect to the estates of individuals dying in January through April of 1987, the due date for filing Schedule S (Form 706) and paying any tax owed under section 4981A(d) is not earlier than February 1, 1988, even if the due date for filing the Schedule 706 and

paying the estate tax imposed by chapter 11 is an earlier date. Further, no interest or penalties will be charged for failure to pay any tax on excess accumulations under section 4981A before January 31, 1988.

c–8: Q. Does the fact that the benefits under a qualified retirement plan or individual retirement account are community property affect the determination of the excise tax under section 4981A?

A. Generally, no. The operation of community property law is disregarded in determining the amount of aggregate annual distributions. Thus, the excise tax under section 4981A is computed without regard to the spouse's community property interest in the individual's or decedent's distributions or accumulation. Also, any reporting to the individual by a trustee, must be done on an aggregate basis without regard to the community property law.

d. Excess Accumulations

d–1: Q. To what extent does section 4981A increase the estate tax imposed by chapter 11 with respect to the estates of any decedents?

A. Section 4981A(d) provides that the estate tax imposed by chapter 11 with respect to the estate of any decedent is increased by an amount equal to 15 percent of the decedent's excess accumulation. See Q&A d–2 through d–7 of this section for rules for determining the decedent's excess accumulation. See Q&A d–8 of this section concerning credits under section 2010 through 2016. See Q&A d–9 of this section for examples illustrating the determination of the increase in estate tax under section 4981A(d).

d–2: Q. How is the amount of a decedent's excess accumulation determined?

A. (a) *General rule.* A decedent's excess accumulation is the excess of (1) the aggregate value of the decedent's interests in all qualified employer plans and individual retirement plans (decedent's aggregate interest) as of the date of the decedent's death over (2) an amount equal to the present value of a hypothetical life annuity determined under Q&A d–7 of this section. If the personal representative for the individual's estate elects to value the property in the gross estate under section 2032, the applicable valuation date prescribed by section 2032 shall be substituted for the decedent's date of death.

(b) *Other rules.* See Q&A d–3 and d–4 of this section if the decedent or, where appropriate, the decedent's personal representative validly elects the special grandfather rule and has any unused grandfather benefit as of the date of his death. See Q&A d–5 and d–6 of this section to determine the decedent's aggregate interest.

d–3: Q. Does the special grandfather rule apply for purposes of determining the amount of the decedent's excess accumulation?

A. Yes. If a decedent prior to death (or the decedent's personal representative after death) makes an election that satisfied the procedures in Q&A b–3 of this section, the special grandfather rule applies.

d–4: Q. How is the decedent's excess accumulation determined if the special grandfather rule applies?

A. If the special grandfather rule applies, the decedent's excess accumulation is the excess of (a) the decedent's aggregate interest (determined under Q&A d–5 of this section) over (b) the greater of (1) the decedent's remaining unrecovered grandfather amount as of the date of the decedent's death, or (2) an amount equal to the present value of a hypothetical life annuity under Q&A d–7 of this section.

d–5. Q. How is the value of the decedent's aggregate interest as of the applicable valuation date under Q&A d–2 determined?

A. (a) *Method of valuation.* The value of the decedent's aggregate interest on the decedent's date of death is determined in a manner consistent with the valuation of such interests for purposes of determining the individual's gross estate for purposes of chapter 11. If the personal representative for an individual's estate subject to estate tax elects to value the property in the gross estate under section 2032, the decedent's aggregate interest is valued in a manner consistent with the rules prescribed by section 2032 (and other relevant estate tax sections). No adjustments provided in chapter 11 in valuing the gross estate are made. Thus, there

is no adjustment under section 2057 (relating to the sale of certain employer securities).

(b) *Amounts included.* Generally, all amounts payable to beneficiaries of the decedent under any qualified employer plan (including amounts payable to a surviving spouse under a qualified joint and survivor annuity or qualified preretirement survivor annuity) or individual retirement plan, whether or not otherwise included in valuing the decedent's gross estate, are considered to be part of the decedent's interest in such plan.

(c) *Rollover after death.* If any amount is distributed from a qualified employer plan or individual retirement plan within the 60-day period ending on the decedent's date of death and is rolled over to an IRA after such date but within 60 days of the date distributed, the decedent's aggregate interest is increased by the amount rolled over, valued as of the date received by the IRA.

d–6. Q. Are there any reductions in the decedent's aggregate interest?

A. The decedent's aggregate interest is reduced by the following:

(a) *Amount payable to alternate payee.* The amount of any portion of the deceased individual's interest in a qualified employer plan that is payable to an alternate payee in whose income the amount is includible under a qualified domestic relations order within the meaning of section 414(p) (QDRO). However, such portion must be taken into account in determining the excess distribution or the excess accumulation upon the death of such alternate payee for purposes of determining if there is a tax under section 4981A(a) or an increase in the estate tax under section 4981A(d) with respect to such alternate payee.

(b) *Investment in the contract.* The amount of the deceased individual's unrecovered investment, within the meaning of section 72(f), in any qualified employer plan or individual retirement plan.

(c) *Life insurance proceeds.* The excess of any amount payable by reason of the death of the individual under a life insurance contract held under a qualified employer plan over the cash surrender value of such contract immediately before the death of such individual (the amount excludible from income by reason of section 101(a)). Amounts excludible from gross income because of section 101(b) do not reduce the decedent's aggregate interest.

(d) *Interest as a beneficiary.* The amount of the deceased individual's interest in a qualified retirement plan or individual retirement plan by reason of the death of another individual.

d–7. Q. How is the present value of the hypothetical life annuity determined?

A. (a) *General rule.* The hypothetical life annuity is a single life annuity contract that provides for equal annual annuity payments commencing on the decedent's date of death for the life of an individual whose age is the same as the decedent's determined as of the date of the decedent's death. The amount of each annual payment is equal to the greater of $150,000 (unindexed) and $112,500 (as indexed until the date of death). If the decedent elected (or the decedent's personal representative elects) the special grandfather rule, the amount of each annual payment is $112,500 (as indexed until the date of death) even if there is no remaining grandfather amount.

(b) *Determination of age.* The decedent's age as of the decedent's date of death for purposes of valuing the hypothetical life annuity is the decedent's attained age (in whole years) as of the decedent's date of death. For example, if the decedent was born on February 2, 1930, and died on August 3, 1990, the decedent's age for purposes of valuing the hypothetical life annuity is 60.

(c) *Interest rate assumptions.* The present value of the single life annuity described above must then be calculated using the interest rate and mortality assumptions in § 20.2031–7 of the Estate Tax Regulations in effect on the date of death.

d–8: Q. Are any credits, deductions, exclusions, etc. that apply for estate tax purposes allowable as an offset against the excise tax under section 4981A(d) for excess accumulations?

A. No. No credits, deductions, exclusions, etc. that apply for estate tax purposes are allowed to offset the tax imposed under section 4981A(d). Thus, no credits under section 2010 through

2016 or other reductions permitted by Chapter 11 are allowable against the tax under section 4981A(d) for excess accumulations. For example, no credits are allowable for the unified credit against the estate tax, for state death taxes, or for gift taxes.

d–8A. Q. Is the estate liable for the excise tax of 15 percent on the amount of the decedent's excess accumulations?

A. Yes. In all events, the estate is liable for the excise tax of 15 percent on the amount of the decedent's excess accumulations. Transferee liability rules under chapter 11 do apply, however. Similarly, the reimbursement provisions of section 2205 also apply. Additionally, the rules generally applicable for purposes of determining the apportionment of the estate tax apply to the apportionment of the excise tax under section 4981A(d). Thus, the decedent's will or the applicable state apportionment law may provide that the executor is entitled to recover the tax imposed under section 4981A(d) attributable to any property from the beneficiary entitled to receive such property. However, absent such a provision in the decedent's will or in the applicable state apportionment law, the executor is not entitled to recover the tax imposed under section 4981A(d) attributable to any property from the beneficiary entitled to receive such property.

d–9: Q. How is the additional tax computed with respect to a decedent's estate under section 4981A(d)?

A. The determination of the additional tax under section 4981A(d) is illustrated by the following examples:

Example 1. (a) An individual (A) dies on February 1, 199X at age 70 and 9 months. As of A's date of death, A has an interest in a defined benefit plan described in section 401(a) (Plan X). Plan X has never provided for employee contributions. A has no section 72 (f) investment in Plan X. A does not have any interest in any other qualified employer plan or individual retirement plan. The alternate valuation date in section 2032 does not apply. A did not elect to have the special grandfather rule apply. A's interest in Plan X is in the form of a qualified joint and survivor annuity. The value of the remaining payments under the joint and survivor annuity as of A's date of death (determined under D–5) is $2,000,000.

(b) Because A is age 70 and 9 months of A's date of death, A's life expectancy as of A's date of death is calculated using age 70 (A's attained age in whole years on A's date of death). The factor from Table A of § 20.2031–7(f) used to determine the present value of a single life annuity for an individual age 70 is 6.0522. The greater of $150,000 or $112,500 indexed for 199X is 150,000. The present value of the hypothetical single life annuity is $907,830 ($150,000×6.0522)

(c) The amount of A's excess accumulation is $1,092,170, determined as follows: $2,000,000 (value of A's interest in Plan X) minus $907,830 (value of hypothetical single life annuity contract) equals $1,092,170.

(d) The increase in the estate tax under section 4981A(d) is $163,825 (15 percent of $1,092,170).

Example 2. (a) The facts are the same as in *Example 1*, except that A's interest in Plan X consists of the following:

(1) $2,000,000, value of employer-provided portion of a qualified joint and survivor annuity determined as of A's date of death using the interest and mortality assumptions in § 20.2031–7.

(2) $200,000, proceeds of a term life insurance contract (no cash surrender value before death).

(3) $100,000. amount (employer-provided portion) payable to A's former spouse pursuant to a QDRO.

(4) $100,000, amount of A's investment in Plan X.

(b) The value of A's interest in Plan X for purposes of calculating A's excess accumulation is still $2,000,000. The proceeds of the term life insurance contract, the amount payable under the QDRO, and the amount of A's investment in Plan X are excluded from such value.

Example 3. (a) The facts are the same as in *Example 1*, except that A elected the special grandfather rule. A's initial grandfather amount was $1,100,000. As of A's date of death, A had received $500,000 in distributions that were treated as a return of A's grandfather amount. Thus, A's unused grandfather amount is $600,000 ($1,100,000–$500,000). In 199X, assume that $112,500 indexed is still $112,500.

(b) A's excess retirement accumulation is determined as follows: $2,000,000 minus the greater of (1) $600,000 or (2) the present value of a period certain annuity of $112,500 a year for 16 years. The present value of a single life annuity of $112,500 a year for an individual age 70 is determined as follows: $112,500 × 6.0522=$680,827.25. $680,827.25 is greater than $600,000. Thus the amount of the excess retirement accumulation is $1,319,173 ($2,000,000 minus $680,827).

(c) The additional estate tax under section 4981A(d) is $197,875 (15 percent of $1,319,173).

Example 4. (a) The facts are the same as in *Example 3* except that, as of A's date of

death, A received $90,000 in distributions that were treated as a return of A's grandfather amount. Thus, A's unused grandfather amount is $1,010,000 ($1,100,000–$90,000).

(b) A's excess retirement accumulation is determined as follows: $2,000,000 minus the greater of (1) ($1,010,000 (A's unused grandfather amount) or (2) 680,827.25 (the present value of a single life annuity of $112,500 a year for an individual age 70). A's unused grandfather amount is greater than the present value of the hypothetical life annuity. Thus, the amount of the excess retirement accumulation is $990,000 ($2,000,000–$1,010,000).

(c) The additional estate tax under section 4981A(d) is $148,500 (15 percent of $990,000).

d–10: Q. if a surviving spouse rolls over a distribution from a qualified retirement plan or an individual retirement plan of the decedent to an individual retirement plan (IRA) established in the spouse's own name, is any distribution in a calendar year from the IRA receiving such rollover included in determining the spouse's excess distribution or excess accumulation in such calendar year?

A. (a) *General rule.* If a surviving spouse rolls over a distribution from a qualified retirement plan or an individual retirement plan of the decedent to an individual retirement plan (IRA) established in the spouse's own name with the rollover contribution and no other contributions or transfers are made to the IRA receiving the rollover contribution, distributions from such IRA will be excluded in determining the spouse's excess distributions and the value of the IRA will be excluded in determining the spouse's excess accumulation. If the surviving spouse rolls over a distribution from a qualified retirement plan or IRA of the decedent to an IRA for which the spouse has prior contributions or makes additional contributions to the IRA receiving the distribution, distributions from the IRA will be included in determining the amount of the excess distributions received by the spouse for the calendar year of the distribution and the value of the IRA at the applicable valuation date will be included in determining the spouse's excess accumulation.

(b) *Special rules.* The rule in paragraph (a) of this Q&A d–10 also applies if a surviving spouse elects to treat an inherited IRA (described in section 408(d)(3)(C)(ii)) as the spouse's own IRA as long as the surviving spouse makes no further contributions to such IRA.

(c) *Other beneficiaries.* Rules similar to the rules in paragraphs (a) and (b) shall apply to an individual who elected to treat an IRA as subject to the distribution requirements of section 408(a)(6), prior to amendment by section 521(b) of TRA '84, under § 1.408–2(b)(7)(ii) of the Income Tax Regulations.

d–11. Q. To what estates does the excise tax under section 4981A(d) apply?

A. The excise tax under section 4981A(d) applies to estates of decedents dying after December 31, 1986.

d–12: Q. Is the aggregate interest reduced by distributions described in paragraph (b)(1) of Q&A c–6 of this section (distributions prior to January 1, 1988, made on account of certain terminations of a qualified employer plan) which are made after the individual's death.

A. Yes, the value of the individual's aggregate interest determined under Q&A d–5 of this section is reduced by distributions described in paragraph (b)(1) of Q&A c–6 of this section which are made after the individual's death.

[T.D. 8165, 52 FR 46750, Dec. 10, 1987; 53 FR 18975, May 26, 1988]

§ 54.6011–1 General requirement of return, statement, or list.

(a) *Minimum funding standards or excess contributions for self-employed individuals and section 403(b)(7)(A) custodial accounts.* Any employer or individual liable for tax under section 4971, 4972 or 4973(a)(2) (for a custodial account under section 403(b)(7)(A)) shall file an annual return on Form 5330 and shall include therein the information required by such form and the instructions issued with respect thereto.

(b) *Tax on prohibited transactions.* Every disqualified person (as defined in section 4975(e)(2)) liable for the tax imposed under section 4975(a) with respect to a prohibited transaction shall file an annual return on Form 5330 and shall include therein the information required by such form and the instructions issued with respect thereto. The annual return on Form 5330 shall be filed with respect to each prohibited transaction and for each taxable year

(or part thereof) of the disqualified person in the taxable period (as defined in section 4975(f)(2)) beginning on the date on which such prohibited transaction occurs.

(c) [Reserved] For further guidance, see § 54.6011–1T(c).

(d) *Effective/applicability date.* For the applicability date of paragraph (c) of this section, see § 54.6011–1T(d).

[T.D. 7838, 47 FR 44249, Oct. 7, 1982, as amended by T.D. 9334, 72 FR 36873, July 6, 2007]

§ 54.6011–1T General requirement of return, statement, or list (temporary).

(a) *Tax on reversions of qualified plan assets to employer.* Every employer liable for the tax imposed under section 4980(a) with respect to an employer reversion (as defined in section 4980(c)(2)) shall file a quarterly return on Form 5330 and shall include therein the information required by such form and the instructions issued with respect thereto. The quarterly return on Form 5330 shall be filed with respect to employer reversions from each qualified plan (as defined in section 4980(c)(1)).

(b) [Reserved]

(c) *Entity manager tax on prohibited tax shelter transactions*—(1) *In general.* Any entity manager of a tax-exempt entity described in section 4965(c)(4), (c)(5), (c)(6), or (c)(7) who is liable for tax under section 4965(a)(2) shall file a return on Form 5330, ''Return of Excise Taxes Related to Employee Benefit Plans,'' on or before the 15th day of the fifth month following the close of such entity manager's taxable year during which the entity entered into the prohibited tax shelter transaction, and shall include therein the information required by such form and the instructions issued with respect thereto.

(2) *Transition rule.* A Form 5330, ''Return of Excise Taxes Related to Employee Benefit Plans,'' for an excise tax under section 4965 that is or was due on or before October 4, 2007 will be deemed to have been filed on the due date if it is filed by October 4, 2007 and if the section 4965 tax that was required to be reported on that Form 5330 is paid by October 4, 2007.

(d) *Effective/applicability date*—(1) *In general.* Paragraph (c) of this section is applicable on July 6, 2007.

(2) *Expiration date.* Paragraph (c) of this section will expire on July 6, 2010.

[T.D. 8133, 52 FR 10563, Apr. 2, 1987 as amended by T.D. 9334, 72 FR 36873, July 6, 2007; 72 FR 45895, Aug. 16, 2007]

§ 54.6011–2 General requirement of return, statement, or list.

Effective for any Form 8928 that is due on or after January 1, 2010, any person liable for tax under section 4980B, 4980D, 4980E, or 4980G of the Code shall file a return with respect to the tax on Form 8928. The return must include the information required by Form 8928 and the instructions issued with respect to it.

[T.D. 9457, 74 FR 45999, Sept. 8, 2009]

§ 54.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

(a) *In general.* If a transaction is identified as a *listed transaction* or a *transaction of interest* as defined in § 1.6011–4 of this chapter by the Commissioner in published guidance (see § 601.601(d)(2)(ii)(*b*) of this chapter), and the listed transaction or transaction of interest involves an excise tax under chapter 43 of subtitle D of the Internal Revenue Code (relating to qualified pension, etc., plans) the transaction must be disclosed in the manner stated in such published guidance.

(b) *Effective/applicability date.* This section applies to listed transactions entered into on or after January 1, 2003. This section applies to transactions of interest entered into on or after November 2, 2006.

[T.D. 9350, 72 FR 43154, Aug. 3, 2007]

§ 54.6060–1 Reporting requirements for tax return preparers.

(a) *In general.* A person that employs one or more tax return preparers to prepare a return or claim for refund under Chapter 43 of subtitle D of the Internal Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and

claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 54.6061–1 Signing of returns and other documents.

Effective for any Form 8928 that is due on or after January 1, 2010, any return, statement, or other document required to be made with respect to a tax imposed by section 4980B, 4980D, 4980E, or 4980G of the Code or the regulations under section 4980B, 4980D, 4980E, or 4980G must be signed by the person required to file the return, statement, or other document, or by the persons required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such return, statement, or document. An individual's signature on such return, statement, or other document shall be prima facie evidence that the individual is authorized to sign the return, statement, or other document.

[T.D. 9457, 74 FR 46000, Sept. 8, 2009]

§ 54.6071–1 Time for filing returns.

(a) *Returns under section 4980B.* (1) *Due date for filing of return by employers or other persons responsible for benefits under a group health plan.* If the person liable for the excise tax is an employer or other person responsible for providing or administering benefits under a group health plan (such as an insurer or a third party administrator), the return required by § 54.6011–2 must be filed on or before the due date for filing the person's income tax return and must reflect the portion of the noncompliance period for each failure under section 4980B that falls during the person's taxable year. An extension to file the person's income tax return does not extend the date for filing Form 8928.

(2) *Due date for filing of return by multiemployer plans.* If the person liable for the excise tax is a multiemployer plan, the return required by § 54.6011–2 must be filed on or before the last day of the seventh month following the end of the plan's plan year. The filing of Form 8928 by a plan must reflect the portion of the noncompliance period for each failure under section 4980B that falls during the plan's plan year.

(b) *Returns under section 4980D.* (1) *Due date for filing of return by employers.* If the person liable for the excise tax is an employer, the return required by § 54.6011–2 must be filed on or before the due date for filing the employer's income tax return and must reflect the portion of the noncompliance period for each failure under chapter 100 that falls during the employer's taxable year. An extension to file the employer's income tax return does not extend the date for filing Form 8928.

(2) *Due date for filing of return by multiemployer plans or multiple employer health plans.* If the person liable for the excise tax is a multiemployer plan or a specified multiple employer health plan, the return required by § 54.6011–2 must be filed on or before the last day of the seventh month following the end of the plan's plan year. The filing of Form 8928 by a plan must reflect the portion of the noncompliance period for each failure under chapter 100 that falls during the plan's plan year.

(c) *Returns under section 4980E.* Any employer who is liable for the excise tax under section 4980E must report this tax by filing the return required by § 54.6011–2 on or before the 15th day of the fourth month following the calendar year in which the noncomparable contributions were made.

(d) *Returns under section 4980G.* Any employer who is liable for the excise tax under section 4980E must report this tax by filing the return required by § 54.6011–2 on or before the 15th day of the fourth month following the calendar year in which the noncomparable contributions were made. *See* Q & A–4 of § 54.4980G–1 for the rules on computation of the excise tax under section 4980G.

(e) *Effective/applicability date:* The rules in this section are effective for any Form 8928 that is due on or after January 1, 2010.

[T.D. 9457, 74 FR 46000, Sept. 8, 2009]

§ 54.6091–1 Place for filing excise tax returns under section 4980B, 4980D, 4980E, or 4980G.

Effective for any Form 8928 that is due on or after January 1, 2010, the return required by § 54.6011–2 must be filed at the place specified in the forms

and instructions provided by the Internal Revenue Service.

[T.D. 9457, 74 FR 46000, Sept. 8, 2009]

§ 54.6107–1 Tax return preparer must furnish copy of return or claims for refund to taxpayer and must retain a copy or record.

(a) *In general.* A person who is a signing tax return preparer of any return or claim for refund of tax under Chapter 43 of subtitle D of the Internal Revenue Code, shall furnish a completed copy of the return or claim for refund to the taxpayer, and retain a completed copy or record in the manner stated in § 1.6107–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 54.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund filed.

(a) *In general.* Each tax return or claim for refund of tax under Chapter 43 of subtitle D prepared by one or more signing tax return preparers must include the identifying number of the preparer required by § 1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in § 1.6109–2 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 54.6151–1 Time and place for paying of tax shown on returns.

Effective for any Form 8928 that is due on or after January 1, 2010, the tax shown on any return which is imposed under section 4980B, 4980D, 4980E or 4980G shall, without assessment or notice and demand, be paid to the internal revenue officer with whom the return is filed at the time and place for filing such return (determined without regard to any extension of time for filing the return). For provisions relating to the time and place for filing such return, *see* §§ 54.6071–1 and 54.6091–1.

[T.D. 9457, 74 FR 46000, Sept. 8, 2009]

§ 54.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general.* For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund of tax under Chapter 43 of subtitle D, see § 1.6694–1 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 54.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 43 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 54.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of excise tax under chapter 43 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 54.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection

when a tax return preparer who prepared a return or claim for refund for tax under chapter 43 of subtitle D of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability, and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 54.6695–1 Other assessable penalties with respect to the preparation of tax returns for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under chapter 43 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 54.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules for claims for credit or refund by a tax return preparer who prepared a return or claim for refund for excise tax under chapter 43 of subtitle D of the Internal Revenue Code, the rules under § 1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 54.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see § 301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 54.9801–1 Basis and scope.

(a) *Statutory basis.* This section and sections 54.9801–2 through 54.9801–6, 54.9802–1, 54.9802–2, 54.9802–3T, 54.9811–1, 54.9812–1T, 54.9831–1, and 54.9833–1 (portability sections) implement Chapter 100 of Subtitle K of the Internal Revenue Code of 1986.

(b) *Scope.* A group health plan may provide greater rights to participants and beneficiaries than those set forth in these portability sections. These portability sections set forth minimum requirements for group health plans concerning:

(1) Limitations on a preexisting condition exclusion period.

(2) Certificates and disclosure of previous coverage.

(3) Rules relating to creditable coverage.

(4) Special enrollment periods.

(5) Prohibition against discrimination on the basis of health factors.

(6) Additional requirements prohibiting discrimination based on genetic information.

(c) *Similar requirements under the Employee Retirement Income Security Act and the Public Health Service Act.* Sections 701, 702, 703, 711, 712, 732, and 733 of the Employee Retirement Income Security Act of 1974 and sections 2701, 2702, 2704, 2705, 2721, and 2791 of the Public Health Service Act impose requirements similar to those imposed under Chapter 100 of Subtitle K with respect to health insurance issuers offering group health insurance coverage. See 29 CFR part 2590 and 45 CFR parts 144, 146, and 148. See also part B of Title XXVII of the Public Health Service Act and 45 CFR part 148 for other rules applicable to health insurance offered in

the individual market (defined in § 54.9801–2).

[T.D. 9166, 69 FR 78746, Dec. 30, 2004, as amended by T.D. 9299, 71 FR 75056, Dec. 13, 2006; T.D. 9427, 73 FR 62419, Oct. 20, 2008; T.D. 9464, 74 FR 51678, Oct. 7, 2009]

§ 54.9801–2 Definitions.

Unless otherwise provided, the definitions in this section govern in applying the provisions of § 54.9801–1, this section, §§ 54.9801–3 through 54.9801–6, 54.9802–1, 54.9802–2, 54.9802–3T, 54.9811–1, 54.9812–1T, 54.9831–1, and 54.9833–1.

Affiliation period means a period of time that must expire before health insurance coverage provided by an HMO becomes effective, and during which the HMO is not required to provide benefits.

COBRA definitions:

(1) *COBRA* means Title X of the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended.

(2) *COBRA continuation coverage* means coverage, under a group health plan, that satisfies an applicable COBRA continuation provision.

(3) *COBRA continuation provision* means section 4980B (other than paragraph (f)(1) of section 4980B insofar as it relates to pediatric vaccines), sections 601–608 of ERISA, or Title XXII of the PHS Act.

(4) *Exhaustion of COBRA continuation coverage* means that an individual's COBRA continuation coverage ceases for any reason other than either failure of the individual to pay premiums on a timely basis, or for cause (such as making a fraudulent claim or an intentional misrepresentation of a material fact in connection with the plan). An individual is considered to have exhausted COBRA continuation coverage if such coverage ceases—

(i) Due to the failure of the employer or other responsible entity to remit premiums on a timely basis;

(ii) When the individual no longer resides, lives, or works in the service area of an HMO or similar program (whether or not within the choice of the individual) and there is no other COBRA continuation coverage available to the individual; or

(iii) When the individual incurs a claim that would meet or exceed a lifetime limit on all benefits and there is no other COBRA continuation coverage available to the individual.

Condition means a *medical condition*.

Creditable coverage means *creditable coverage* within the meaning of § 54.9801–4(a).

Dependent means any individual who is or may become eligible for coverage under the terms of a group health plan because of a relationship to a participant.

Employee Retirement Income Security Act of 1974 (ERISA) means the Employee Retirement Income Security Act of 1974, as amended (29 U.S.C. 1001 *et seq.*).

Enroll means to become covered for benefits under a group health plan (that is, when coverage becomes effective), without regard to when the individual may have completed or filed any forms that are required in order to become covered under the plan. For this purpose, an individual who has health coverage under a group health plan is enrolled in the plan regardless of whether the individual elects coverage, the individual is a dependent who becomes covered as a result of an election by a participant, or the individual becomes covered without an election.

Enrollment date definitions (*enrollment date*, *first day of coverage*, and *waiting period*) are set forth in § 54.9801–3(a)(3)(i), (ii), and (iii).

Excepted benefits means the benefits described as excepted in § 54.9831(c).

Genetic information has the meaning given the term in § 54.9802–3T(a)(3).

Group health insurance coverage means health insurance coverage offered in connection with a group health plan.

Group health plan or *plan* means a *group health plan* within the meaning of § 54.9831(a).

Group market means the market for health insurance coverage offered in connection with a group health plan. (However, certain very small plans may be treated as being in the *individual market*, rather than the group market; see the definition of individual market in this section.)

Health insurance coverage means benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or

certificate, hospital or medical service plan contract, or HMO contract offered by a health insurance issuer. Health insurance coverage includes group health insurance coverage, individual health insurance coverage, and short-term, limited-duration insurance. However, benefits described in § 54.9831(c)(2) are not treated as benefits consisting of medical care.

Health insurance issuer or *issuer* means an insurance company, insurance service, or insurance organization (including an HMO) that is required to be licensed to engage in the business of insurance in a State and that is subject to State law that regulates insurance (within the meaning of section 514(b)(2) of ERISA). Such term does not include a group health plan.

Health maintenance organization or *HMO* means—

(1) A federally qualified health maintenance organization (as defined in section 1301(a) of the PHS Act);

(2) An organization recognized under State law as a health maintenance organization; or

(3) A similar organization regulated under State law for solvency in the same manner and to the same extent as such a health maintenance organization.

Individual health insurance coverage means health insurance coverage offered to individuals in the individual market, but does not include short-term, limited-duration insurance. Individual health insurance coverage can include dependent coverage.

Individual market means the market for health insurance coverage offered to individuals other than in connection with a group health plan. Unless a State elects otherwise in accordance with section 2791(e)(1)(B)(ii) of the PHS Act, such term also includes coverage offered in connection with a group health plan that has fewer than two participants who are current employees on the first day of the plan year.

Issuer means a *health insurance issuer*.

Late enrollment definitions (*late enrollee* and *late enrollment*) are set forth in § 54.9801–3(a)(3)(v) and (vi) .

Medical care has the meaning given such term by section 213(d), determined without regard to section 213(d)(1)(C) and so much of section 213(d)(1)(D) as relates to qualified long-term care insurance.

Medical condition or *condition* means any condition, whether physical or mental, including, but not limited to, any condition resulting from illness, injury (whether or not the injury is accidental), pregnancy, or congenital malformation. However, genetic information is not a condition.

Participant means *participant* within the meaning of section 3(7) of ERISA.

Placement, or being placed, for adoption means the assumption and retention of a legal obligation for total or partial support of a child by a person with whom the child has been placed in anticipation of the child's adoption. The child's placement for adoption with such person ends upon the termination of such legal obligation.

Plan year means the year that is designated as the plan year in the plan document of a group health plan, except that if the plan document does not designate a plan year or if there is no plan document, the plan year is—

(1) The deductible or limit year used under the plan;

(2) If the plan does not impose deductibles or limits on a yearly basis, then the plan year is the policy year;

(3) If the plan does not impose deductibles or limits on a yearly basis, and either the plan is not insured or the insurance policy is not renewed on an annual basis, then the plan year is the employer's taxable year; or

(4) In any other case, the plan year is the calendar year.

Preexisting condition exclusion means *preexisting condition exclusion* within the meaning of § 54.9801–3(a)(1).

Public health plan means *public health plan* within the meaning of § 54.9801–4(a)(1)(ix).

Public Health Service Act (PHS Act) means the Public Health Service Act (42 U.S.C. 201, *et seq.*).

Short-term, limited-duration insurance means health insurance coverage provided pursuant to a contract with an issuer that has an expiration date specified in the contract (taking into account any extensions that may be elected by the policyholder without the issuer's consent) that is less than 12 months after the original effective date of the contract.

Significant break in coverage means a *significant break in coverage* within the meaning of § 54.9801–4(b)(2)(iii).

Special enrollment means enrollment in a group health plan under the rights described in § 54.9801–6 or in group health insurance coverage under the rights described in 29 CFR 2590.701–6 or 45 CFR 146.117.

State health benefits risk pool means a *State health benefits risk pool* within the meaning of § 54.9801–4(a)(1)(vii).

Waiting period means *waiting period* within the meaning of § 54.9801–3(a)(3)(iii).

[T.D. 9166, 69 FR 78746, Dec. 30, 2004, as amended by T.D. 9299, 71 FR 75056, Dec. 13, 2006; T.D. 9427, 73 FR 62420, Oct. 20, 2008; T.D. 9464, 74 FR 51678, Oct. 7, 2009]

§ 54.9801–3 Limitations on preexisting condition exclusion period.

(a) *Preexisting condition exclusion*—(1) *Defined*—(i) A *preexisting condition exclusion* means a limitation or exclusion of benefits relating to a condition based on the fact that the condition was present before the effective date of coverage under a group health plan or group health insurance coverage, whether or not any medical advice, diagnosis, care, or treatment was recommended or received before that day. A preexisting condition exclusion includes any exclusion applicable to an individual as a result of information relating to an individual's health status before the individual's effective date of coverage under a group health plan or group health insurance coverage, such as a condition identified as a result of a pre-enrollment questionnaire or physical examination given to the individual, or review of medical records relating to the pre-enrollment period.

(ii) *Examples*. The rules of this paragraph (a)(1) are illustrated by the following examples:

Example 1. (i) *Facts*. A group health plan provides benefits solely through an insurance policy offered by Issuer *S*. At the expiration of the policy, the plan switches coverage to a policy offered by Issuer *T*. Issuer *T*'s policy excludes benefits for any prosthesis if the body part was lost before the effective date of coverage under the policy.

(ii) *Conclusion*. In this *Example 1*, the exclusion of benefits for any prosthesis if the body part was lost before the effective date of coverage is a preexisting condition exclusion because it operates to exclude benefits for a condition based on the fact that the condition was present before the effective date of coverage under the policy. (Therefore, the exclusion of benefits is required to comply with the limitations on preexisting condition exclusions in this section. For an example illustrating the application of these limitations to a succeeding insurance policy, see *Example 3* of paragraph (a)(3)(iv) of this section.)

Example 2. (i) *Facts*. A group health plan provides coverage for cosmetic surgery in cases of accidental injury, but only if the injury occurred while the individual was covered under the plan.

(ii) *Conclusion*. In this *Example 2*, the plan provision excluding cosmetic surgery benefits for individuals injured before enrolling in the plan is a preexisting condition exclusion because it operates to exclude benefits relating to a condition based on the fact that the condition was present before the effective date of coverage. The plan provision, therefore, is subject to the limitations on preexisting condition exclusions in this section.

Example 3. (i) *Facts*. A group health plan provides coverage for the treatment of diabetes, generally not subject to any lifetime dollar limit. However, if an individual was diagnosed with diabetes before the effective date of coverage under the plan, diabetes coverage is subject to a lifetime limit of $10,000.

(ii) *Conclusion*. In this *Example 3*, the $10,000 lifetime limit is a preexisting condition exclusion because it limits benefits for a condition based on the fact that the condition was present before the effective date of coverage. The plan provision, therefore, is subject to the limitations on preexisting condition exclusions in this section.

Example 4. (i) *Facts*. A group health plan provides coverage for the treatment of acne, subject to a lifetime limit of $2,000. The plan counts against this $2,000 lifetime limit on acne treatment benefits provided under prior health coverage.

(ii) *Conclusion*. In this *Example 4*, counting benefits for a specific condition provided under prior health coverage against a lifetime limit for that condition is a preexisting condition exclusion because it operates to limit benefits for a condition based on the fact that the condition was present before the effective date of coverage. The plan provision, therefore, is subject to the limitations on preexisting condition exclusions in this section.

Example 5. (i) *Facts*. When an individual's coverage begins under a group health plan, the individual generally becomes eligible for all benefits. However, benefits for pregnancy are not available until the individual has been covered under the plan for 12 months.

(ii) *Conclusion*. In this *Example 5*, the requirement to be covered under the plan for 12 months to be eligible for pregnancy benefits is a subterfuge for a preexisting condition exclusion because it is designed to exclude benefits for a condition (pregnancy) that arose before the effective date of coverage. Because a plan is prohibited under paragraph (b)(5) of this section from imposing any preexisting condition exclusion on pregnancy, the plan provision is prohibited. However, if the plan provision included an exception for women who were pregnant before the effective date of coverage under the plan (so that the provision applied only to women who became pregnant on or after the effective date of coverage) the plan provision would not be a preexisting condition exclusion (and would not be prohibited by paragraph (b)(5) of this section).

Example 6. (i) *Facts*. A group health plan provides coverage for medically necessary items and services, generally including treatment of heart conditions. However, the plan does not cover those same items and services when used for treatment of congenital heart conditions.

(ii) *Conclusion*. In this *Example 6*, the exclusion of coverage for treatment of congenital heart conditions is a preexisting condition exclusion because it operates to exclude benefits relating to a condition based on the fact that the condition was present before the effective date of coverage. The plan provision, therefore, is subject to the limitations on preexisting condition exclusions in this section.

Example 7. (i) *Facts*. A group health plan generally provides coverage for medically necessary items and services. However, the plan excludes coverage for the treatment of cleft palate.

(ii) *Conclusion*. In this *Example 7*, the exclusion of coverage for treatment of cleft palate is not a preexisting condition exclusion because the exclusion applies regardless of when the condition arose relative to the effective date of coverage. The plan provision, therefore, is not subject to the limitations on preexisting condition exclusions in this section.

Example 8. (i) *Facts*. A group health plan provides coverage for treatment of cleft palate, but only if the individual being treated has been continuously covered under the plan from the date of birth.

(ii) *Conclusion*. In this *Example 8*, the exclusion of coverage for treatment of cleft palate for individuals who have not been covered under the plan from the date of birth operates to exclude benefits in relation to a condition based on the fact that the condition was present before the effective date of coverage. The plan provision, therefore, is subject to the limitations on preexisting condition exclusions in this section.

(2) *General rules*. Subject to paragraph (b) of this section (prohibiting the imposition of a preexisting condition exclusion with respect to certain individuals and conditions), a group health plan may impose, with respect to a participant or beneficiary, a preexisting condition exclusion only if the requirements of this paragraph (a)(2) are satisfied. (*See* section 701 of ERISA and section 2701 of the PHS Act, under which these requirements are also imposed on a health insurance issuer offering group health insurance coverage.)

(i) *6-month look-back rule*. A preexisting condition exclusion must relate to a condition (whether physical or mental), regardless of the cause of the condition, for which medical advice, diagnosis, care, or treatment was recommended or received within the 6-month period (or such shorter period as applies under the plan) ending on the enrollment date.

(A) For purposes of this paragraph (a)(2)(i), medical advice, diagnosis, care, or treatment is taken into account only if it is recommended by, or received from, an individual licensed or similarly authorized to provide such services under State law and operating within the scope of practice authorized by State law.

(B) For purposes of this paragraph (a)(2)(i), the 6-month period ending on the enrollment date begins on the 6-month anniversary date preceding the enrollment date. For example, for an enrollment date of August 1, 1998, the 6-month period preceding the enrollment date is the period commencing on February 1, 1998 and continuing through July 31, 1998. As another example, for an enrollment date of August 30, 1998, the 6-month period preceding the enrollment date is the period commencing on February 28, 1998 and continuing through August 29, 1998.

(C) The rules of this paragraph (a)(2)(i) are illustrated by the following examples:

Example 1. (i) *Facts*. Individual *A* is diagnosed with a medical condition 8 months before *A*'s enrollment date in Employer *R*'s group health plan. *A*'s doctor recommends that *A* take a prescription drug for 3 months, and *A* follows the recommendation.

(ii) *Conclusion*. In this *Example 1*, Employer *R*'s plan may impose a preexisting condition

exclusion with respect to *A*'s condition because *A* received treatment during the 6-month period ending on *A*'s enrollment date in Employer *R*'s plan by taking the prescription medication during that period. However, if *A* did not take the prescription drug during the 6-month period, Employer *R*'s plan would not be able to impose a preexisting condition exclusion with respect to that condition.

Example 2. (i) *Facts.* Individual *B* is treated for a medical condition 7 months before the enrollment date in Employer *S*'s group health plan. As part of such treatment, *B*'s physician recommends that a follow-up examination be given 2 months later. Despite this recommendation, *B* does not receive a follow-up examination, and no other medical advice, diagnosis, care, or treatment for that condition is recommended to *B* or received by *B* during the 6-month period ending on *B*'s enrollment date in Employer *S*'s plan.

(ii) *Conclusion.* In this *Example 2*, Employer *S*'s plan may not impose a preexisting condition exclusion with respect to the condition for which *B* received treatment 7 months prior to the enrollment date.

Example 3. (i) *Facts.* Same facts as *Example 2*, except that Employer *S*'s plan learns of the condition and attaches a rider to *B*'s certificate of coverage excluding coverage for the condition. Three months after enrollment, *B*'s condition recurs, and Employer *S*'s plan denies payment under the rider.

(ii) *Conclusion.* In this *Example 3*, the rider is a preexisting condition exclusion and Employer *S*'s plan may not impose a preexisting condition exclusion with respect to the condition for which *B* received treatment 7 months prior to the enrollment date. (In addition, such a rider would violate the provisions of § 54.9802–1, even if *B* had received treatment for the condition within the 6-month period ending on the enrollment date.)

Example 4. (i) *Facts.* Individual *C* has asthma and is treated for that condition several times during the 6-month period before *C*'s enrollment date in Employer *T*'s plan. Three months after the enrollment date, *C* begins coverage under Employer *T*'s plan. Two months later, *C* is hospitalized for asthma.

(ii) *Conclusion.* In this *Example 4*, Employer *T*'s plan may impose a preexisting condition exclusion with respect to *C*'s asthma because care relating to *C*'s asthma was received during the 6-month period ending on *C*'s enrollment date (which, under the rules of paragraph (a)(3)(i) of this section, is the first day of the waiting period).

Example 5. (i) *Facts.* Individual *D*, who is subject to a preexisting condition exclusion imposed by Employer *U*'s plan, has diabetes, as well as retinal degeneration, a foot condition, and poor circulation (all of which are conditions that may be directly attributed to diabetes). *D* receives treatment for these conditions during the 6-month period ending on *D*'s enrollment date in Employer *U*'s plan. After enrolling in the plan, *D* stumbles and breaks a leg.

(ii) *Conclusion.* In this *Example 5*, the leg fracture is not a condition related to *D*'s diabetes, retinal degeneration, foot condition, or poor circulation, even though they may have contributed to the accident. Therefore, benefits to treat the leg fracture cannot be subject to a preexisting condition exclusion. However, any additional medical services that may be needed because of *D*'s preexisting diabetes, poor circulation, or retinal degeneration that would not be needed by another patient with a broken leg who does not have these conditions may be subject to the preexisting condition exclusion imposed under Employer *U*'s plan.

(ii) *Maximum length of preexisting condition exclusion.* A preexisting condition exclusion is not permitted to extend for more than 12 months (18 months in the case of a late enrollee) after the enrollment date. For example, for an enrollment date of August 1, 1998, the 12-month period after the enrollment date is the period commencing on August 1, 1998 and continuing through July 31, 1999; the 18-month period after the enrollment date is the period commencing on August 1, 1998 and continuing through January 31, 2000.

(iii) *Reducing a preexisting condition exclusion period by creditable coverage*—(A) The period of any preexisting condition exclusion that would otherwise apply to an individual under a group health plan is reduced by the number of days of creditable coverage the individual has as of the enrollment date, as counted under § 54.9801–4. Creditable coverage may be evidenced through a certificate of creditable coverage (required under § 54.9801–5(a)), or through other means in accordance with the rules of § 54.9801–5(c).

(B) The rules of this paragraph (a)(2)(iii) are illustrated by the following example:

Example. (i) *Facts.* Individual *D* works for Employer *X* and has been covered continuously under *X*'s group health plan. *D*'s spouse works for Employer *Y*. *Y* maintains a group health plan that imposes a 12-month preexisting condition exclusion (reduced by creditable coverage) on all new enrollees. *D* enrolls in *Y*'s plan, but also stays covered under *X*'s plan. *D* presents *Y*'s plan with evidence of creditable coverage under *X*'s plan.

(ii) *Conclusion*. In this *Example*, *Y*'s plan must reduce the preexisting condition exclusion period that applies to *D* by the number of days of coverage that *D* had under *X*'s plan as of *D*'s enrollment date in *Y*'s plan (even though *D*'s coverage under *X*'s plan was continuing as of that date).

(iv) *Other standards*. See § 54.9802–1 for other standards that may apply with respect to certain benefit limitations or restrictions under a group health plan. Other laws may also apply, such as the Uniformed Services Employment and Reemployment Rights Act (USERRA), which can affect the application of a preexisting condition exclusion to certain individuals who are reinstated in a group health plan following active military service.

(3) *Enrollment definitions*—(i) *Enrollment date* means the first day of coverage (as described in paragraph (a)(3)(ii) of this section) or, if there is a waiting period, the first day of the waiting period. If an individual receiving benefits under a group health plan changes benefit packages, or if the plan changes group health insurance issuers, the individual's enrollment date does not change.

(ii) *First day of coverage* means, in the case of an individual covered for benefits under a group health plan, the first day of coverage under the plan and, in the case of an individual covered by health insurance coverage in the individual market, the first day of coverage under the policy or contract.

(iii) *Waiting period* means the period that must pass before coverage for an employee or dependent who is otherwise eligible to enroll under the terms of a group health plan can become effective. If an employee or dependent enrolls as a late enrollee or special enrollee, any period before such late or special enrollment is not a waiting period. If an individual seeks coverage in the individual market, a waiting period begins on the date the individual submits a substantially complete application for coverage and ends on—

(A) If the application results in coverage, the date coverage begins;

(B) If the application does not result in coverage, the date on which the application is denied by the issuer or the date on which the offer of coverage lapses.

(iv) The rules of paragraphs (a)(3)(i), (ii), and (iii) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Employer *V*'s group health plan provides for coverage to begin on the first day of the first payroll period following the date an employee is hired and completes the applicable enrollment forms, or on any subsequent January 1 after completion of the applicable enrollment forms. Employer *V*'s plan imposes a preexisting condition exclusion for 12 months (reduced by the individual's creditable coverage) following an individual's enrollment date. Employee *E* is hired by Employer *V* on October 13, 1998, and on October 14, 1998 *E* completes and files all the forms necessary to enroll in the plan. *E*'s coverage under the plan becomes effective on October 25, 1998 (which is the beginning of the first payroll period after *E*'s date of hire).

(ii) *Conclusion*. In this *Example 1*, *E*'s enrollment date is October 13, 1998 (which is the first day of the waiting period for *E*'s enrollment and is also *E*'s date of hire). Accordingly, with respect to *E*, the permissible 6-month period in paragraph (a)(2)(i) is the period from April 13, 1998 through October 12, 1998, the maximum permissible period during which Employer *V*'s plan can apply a preexisting condition exclusion under paragraph (a)(2)(ii) is the period from October 13, 1998 through October 12, 1999, and this period must be reduced under paragraph (a)(2)(iii) by *E*'s days of creditable coverage as of October 13, 1998.

Example 2. (i) *Facts*. A group health plan has two benefit package options, Option 1 and Option 2. Under each option a 12-month preexisting condition exclusion is imposed. Individual *B* is enrolled in Option 1 on the first day of employment with the employer maintaining the plan, remains enrolled in Option 1 for more than one year, and then decides to switch to Option 2 at open season.

(ii) *Conclusion*. In this *Example 2*, *B* cannot be subject to any preexisting condition exclusion under Option 2 because any preexisting condition exclusion period would have to begin on *B*'s enrollment date, which is *B*'s first day of coverage, rather than the date that *B* enrolled in Option 2. Therefore, the preexisting condition exclusion period expired before *B* switched to Option 2.

Example 3. (i) *Facts*. On May 13, 1997, Individual *E* is hired by an employer and enrolls in the employer's group health plan. The plan provides benefits solely through an insurance policy offered by Issuer *S*. On December 27, 1998, *E*'s leg is injured in an accident and the leg is amputated. On January 1, 1999, the plan switches coverage to a policy offered by Issuer *T*. Issuer *T*'s policy excludes benefits for any prosthesis if the body part was lost before the effective date of coverage under the policy.

(ii) *Conclusion*. In this *Example 3*, *E*'s enrollment date is May 13, 1997, *E*'s first day of coverage. Therefore, the permissible 6-month look-back period for the preexisting condition exclusion imposed under Issuer *T*'s policy begins on November 13, 1996 and ends on May 12, 1997. In addition, the 12-month maximum permissible preexisting condition exclusion period begins on May 13, 1997 and ends on May 12, 1998. Accordingly, because no medical advice, diagnosis, care, or treatment was recommended to or received by *E* for the leg during the 6-month look-back period (even though medical care was provided within the 6-month period preceding the effective date of *E*'s coverage under Issuer *T*'s policy), the plan may not impose any preexisting condition exclusion with respect to *E*. Moreover, even if *E* had received treatment during the 6-month look-back period, the plan still would not be permitted to impose a preexisting condition exclusion because the 12-month maximum permissible preexisting condition exclusion period expired on May 12, 1998 (before the effective date of *E*'s coverage under Issuer *T*'s policy). See 29 CFR 2590.701–3(a)(3)(iv) *Example 3* and 45 CFR 146.111(a)(3)(iv) *Example 3* for a conclusion that Issuer *T* is similarly prohibited from imposing a preexisting condition exclusion with respect to *E*.

Example 4. (i) *Facts*. A group health plan limits eligibility for coverage to full-time employees of Employer *Y*. Coverage becomes effective on the first day of the month following the date the employee becomes eligible. Employee *C* begins working full-time for Employer *Y* on April 11. Prior to this date, *C* worked part-time for *Y*. *C* enrolls in the plan and coverage is effective May 1.

(ii) *Conclusion*. In this *Example 4*, *C*'s enrollment date is April 11 and the period from April 11 through April 30 is a waiting period. The period while *C* was working part-time, and therefore not in an eligible class of employees, is not part of the waiting period.

Example 5. (i) *Facts*. To be eligible for coverage under a multiemployer group health plan in the current calendar quarter, the plan requires an individual to have worked 250 hours in covered employment during the previous quarter. If the hours requirement is satisfied, coverage becomes effective on the first day of the current calendar quarter. Employee *D* begins work on January 28 and does not work 250 hours in covered employment during the first quarter (ending March 31). *D* works at least 250 hours in the second quarter (ending June 30) and is enrolled in the plan with coverage effective July 1 (the first day of the third quarter).

(ii) *Conclusion*. In this *Example 5*, *D*'s enrollment date is the first day of the quarter during which *D* satisfies the hours requirement, which is April 1. The period from April 1 through June 30 is a waiting period.

(v) *Late enrollee* means an individual whose enrollment in a plan is a late enrollment.

(vi) (A) *Late enrollment* means enrollment of an individual under a group health plan other than—

(*1*) On the earliest date on which coverage can become effective for the individual under the terms of the plan; or

(*2*) Through special enrollment. (For rules relating to special enrollment, see § 54.9801–6.)

(B) If an individual ceases to be eligible for coverage under the plan, and then subsequently becomes eligible for coverage under the plan, only the individual's most recent period of eligibility is taken into account in determining whether the individual is a late enrollee under the plan with respect to the most recent period of coverage. Similar rules apply if an individual again becomes eligible for coverage following a suspension of coverage that applied generally under the plan.

(vii) *Examples*. The rules of paragraphs (a)(3)(v) and (vi) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Employee *F* first becomes eligible to be covered by Employer *W*'s group health plan on January 1, 1999 but elects not to enroll in the plan until a later annual open enrollment period, with coverage effective January 1, 2001. *F* has no special enrollment right at that time.

(ii) *Conclusion*. In this *Example 1*, *F* is a late enrollee with respect to *F*'s coverage that became effective under the plan on January 1, 2001.

Example 2. (i) *Facts*. Same facts as *Example 1*, except that *F* terminates employment with Employer *W* on July 1, 1999 without having had any health insurance coverage under the plan. *F* is rehired by Employer *W* on January 1, 2000 and is eligible for and elects coverage under Employer *W*'s plan effective on January 1, 2000.

(ii) *Conclusion*. In this *Example 2*, *F* would not be a late enrollee with respect to *F*'s coverage that became effective on January 1, 2000.

(b) *Exceptions pertaining to preexisting condition exclusions*—(1) *Newborns*—(i) *In general*. Subject to paragraph (b)(3) of this section, a group health plan may not impose any preexisting condition exclusion on a child who, within 30 days after birth, is covered under any creditable coverage. Accordingly, if a child is enrolled in a group health plan

(or other creditable coverage) within 30 days after birth and subsequently enrolls in another group health plan without a significant break in coverage (as described in § 54.9801–4(b)(2)(iii)), the other plan may not impose any preexisting condition exclusion on the child.

(ii) *Examples*. The rules of this paragraph (b)(1) are illustrated by the following examples:

Example 1. (i) *Facts*. Individual *E*, who has no prior creditable coverage, begins working for Employer *W* and has accumulated 210 days of creditable coverage under Employer *W*'s group health plan on the date *E* gives birth to a child. Within 30 days after the birth, the child is enrolled in the plan. Ninety days after the birth, both *E* and the child terminate coverage under the plan. Both *E* and the child then experience a break in coverage of 45 days before *E* is hired by Employer *X* and the two are enrolled in Employer *X*'s group health plan.

(ii) *Conclusion*. In this *Example 1*, because *E*'s child is enrolled in Employer *W*'s plan within 30 days after birth, no preexisting condition exclusion may be imposed with respect to the child under Employer *W*'s plan. Likewise, Employer *X*'s plan may not impose any preexisting condition exclusion on *E*'s child because the child was covered under creditable coverage within 30 days after birth and had no significant break in coverage before enrolling in Employer *X*'s plan. On the other hand, because *E* had only 300 days of creditable coverage prior to *E*'s enrollment date in Employer *X*'s plan, Employer *X*'s plan may impose a preexisting condition exclusion on *E* for up to 65 days (66 days if the 12-month period after *E*'s enrollment date in *X*'s plan includes February 29).

Example 2. (i) *Facts*. Individual *F* is enrolled in a group health plan in which coverage is provided through a health insurance issuer. *F* gives birth. Under State law applicable to the health insurance issuer, health care expenses incurred for the child during the 30 days following birth are covered as part of *F*'s coverage. Although *F* may obtain coverage for the child beyond 30 days by timely requesting special enrollment and paying an additional premium, the issuer is prohibited under State law from recouping the cost of any expenses incurred for the child within the 30-day period if the child is not later enrolled.

(ii) *Conclusion*. In this *Example 2*, the child is covered under creditable coverage within 30 days after birth, regardless of whether the child enrolls as a special enrollee under the plan. Therefore, no preexisting condition exclusion may be imposed on the child unless the child has a significant break in coverage.

(2) *Adopted children*. Subject to paragraph (b)(3) of this section, a group health plan may not impose any preexisting condition exclusion on a child who is adopted or placed for adoption before attaining 18 years of age and who, within 30 days after the adoption or placement for adoption, is covered under any creditable coverage. Accordingly, if a child is enrolled in a group health plan (or other creditable coverage) within 30 days after adoption or placement for adoption and subsequently enrolls in another group health plan without a significant break in coverage (as described in § 54.9801–4(b)(2)(iii)), the other plan may not impose any preexisting condition exclusion on the child. This rule does not apply to coverage before the date of such adoption or placement for adoption.

(3) *Significant break in coverage*. Paragraphs (b)(1) and (2) of this section no longer apply to a child after a significant break in coverage. (*See* § 54.9801–4(b)(2)(iii) for rules relating to the determination of a significant break in coverage.)

(4) *Special enrollment*. For special enrollment rules relating to new dependents, see § 54.9801–6(b).

(5) *Pregnancy*. A group health plan may not impose a preexisting condition exclusion relating to pregnancy.

(6) *Genetic information*—(i) A group health plan may not impose a preexisting condition exclusion relating to a condition based solely on genetic information. However, if an individual is diagnosed with a condition, even if the condition relates to genetic information, the plan may impose a preexisting condition exclusion with respect to the condition, subject to the other limitations of this section.

(ii) The rules of this paragraph (b)(6) are illustrated by the following example:

Example. (i) *Facts*. Individual *A* enrolls in a group health plan that imposes a 12-month maximum preexisting condition exclusion. Three months before *A*'s enrollment, *A*'s doctor told *A* that, based on genetic information, *A* has a predisposition towards breast cancer. *A* was not diagnosed with breast cancer at any time prior to *A*'s enrollment date in the plan. Nine months after *A*'s enrollment date in the plan, *A* is diagnosed with breast cancer.

(ii) *Conclusion*. In this *Example*, the plan may not impose a preexisting condition exclusion with respect to *A*'s breast cancer because, prior to *A*'s enrollment date, *A* was not diagnosed with breast cancer.

(c) *General notice of preexisting condition exclusion*. A group health plan imposing a preexisting condition exclusion must provide a written general notice of preexisting condition exclusion to participants under the plan and cannot impose a preexisting condition exclusion with respect to a participant or a dependent of the participant until such a notice is provided. (See 29 CFR 2590.701–3(c) and 45 CFR 146.111(c), which also impose this requirement on a health insurance issuer offering group health insurance coverage subject to a preexisting condition exclusion.)

(1) *Manner and timing*. A plan must provide the general notice of preexisting condition exclusion as part of any written application materials distributed by the plan for enrollment. If the plan does not distribute such materials, the notice must be provided by the earliest date following a request for enrollment that the plan, acting in a reasonable and prompt fashion, can provide the notice.

(2) *Content*. The general notice of preexisting condition exclusion must notify participants of the following:

(i) The existence and terms of any preexisting condition exclusion under the plan. This description includes the length of the plan's look-back period (which is not to exceed 6 months under paragraph (a)(2)(i) of this section); the maximum preexisting condition exclusion period under the plan (which cannot exceed 12 months (or 18 months for late enrollees) under paragraph (a)(2)(ii) of this section); and how the plan will reduce the maximum preexisting condition exclusion period by creditable coverage (described in paragraph (a)(2)(iii) of this section).

(ii) A description of the rights of individuals to demonstrate creditable coverage, and any applicable waiting periods, through a certificate of creditable coverage (as required by § 54.9801–5(a)) or through other means (as described in § 54.9801–5(c)). This must include a description of the right of the individual to request a certificate from a prior plan or issuer, if necessary, and a statement that the current plan will assist in obtaining a certificate from any prior plan or issuer, if necessary.

(iii) A person to contact (including an address or telephone number) for obtaining additional information or assistance regarding the preexisting condition exclusion.

(3) *Duplicate notices not required*. If a notice satisfying the requirements of this paragraph (c) is provided to an individual by another party, the plan's obligation to provide a general notice of preexisting condition exclusion with respect to that individual is satisfied. (See 29 CFR 2590.701–3(c)(3) and 45 CFR 146.111(c)(3), which provide that the issuer's obligation is similarly satisfied.)

(4) *Example with sample language*. The rules of this paragraph (c) are illustrated by the following example, which includes sample language that plans can use as a basis for preparing their own notices to satisfy the requirements of this paragraph (c):

Example. (i) *Facts*. A group health plan makes coverage effective on the first day of the first calendar month after hire and on each January 1 following an open season. The plan imposes a 12-month maximum preexisting condition exclusion (18 months for late enrollees) and uses a 6-month look-back period. As part of the enrollment application materials, the plan provides the following statement:

This plan imposes a preexisting condition exclusion. This means that if you have a medical condition before coming to our plan, you might have to wait a certain period of time before the plan will provide coverage for that condition. This exclusion applies only to conditions for which medical advice, diagnosis, care, or treatment was recommended or received within a six-month period. Generally, this six-month period ends the day before your coverage becomes effective. However, if you were in a waiting period for coverage, the six-month period ends on the day before the waiting period begins. The preexisting condition exclusion does not apply to pregnancy nor to a child who is enrolled in the plan within 30 days after birth, adoption, or placement for adoption.

This exclusion may last up to 12 months (18 months if you are a late enrollee) from your first day of coverage, or, if you were in a waiting period, from the first day of your waiting period. However, you can reduce the

length of this exclusion period by the number of days of your prior ''creditable coverage.'' Most prior health coverage is creditable coverage and can be used to reduce the preexisting condition exclusion if you have not experienced a break in coverage of at least 63 days. To reduce the 12-month (or 18-month) exclusion period by your creditable coverage, you should give us a copy of any certificates of creditable coverage you have. If you do not have a certificate, but you do have prior health coverage, we will help you obtain one from your prior plan or issuer. There are also other ways that you can show you have creditable coverage. Please contact us if you need help demonstrating creditable coverage.

All questions about the preexisting condition exclusion and creditable coverage should be directed to Individual *B* at Address *M* or Telephone Number *N*.

(ii) *Conclusion*. In this *Example*, the plan satisfies the general notice requirement of this paragraph (c).

(d) *Determination of creditable coverage*—(1) *Determination within reasonable time*. If a group health plan receives creditable coverage information under § 54.9801–5, the plan is required, within a reasonable time following receipt of the information, to make a determination regarding the amount of the individual's creditable coverage and the length of any exclusion that remains. Whether this determination is made within a reasonable time depends on the relevant facts and circumstances. Relevant facts and circumstances include whether a plan's application of a preexisting condition exclusion would prevent an individual from having access to urgent medical care. (See 29 CFR 2590.701–3(d) and 45 CFR 146.111(d), which also impose this requirement on a health insurance issuer offering group health insurance coverage.)

(2) *No time limit on presenting evidence of creditable coverage*. A plan may not impose any limit on the amount of time that an individual has to present a certificate or other evidence of creditable coverage.

(3) *Example*. The rules of this paragraph (d) are illustrated by the following example:

Example. (i) *Facts*. A group health plan imposes a preexisting condition exclusion period of 12 months. After receiving the general notice of preexisting condition exclusion, Individual *H* develops an urgent health condition before receiving a certificate of creditable coverage from *H*'s prior group health plan. *H* attests to the period of prior coverage, presents corroborating documentation of the coverage period, and authorizes the plan to request a certificate on *H*'s behalf in accordance with the rules of § 54.9801–5.

(ii) *Conclusion*. In this *Example*, the plan must review the evidence presented by *H* and make a determination of creditable coverage within a reasonable time that is consistent with the urgency of *H*'s health condition. (This determination may be modified as permitted under paragraph (f) of this section.)

(e) *Individual notice of period of preexisting condition exclusion*. After an individual has presented evidence of creditable coverage and after the plan has made a determination of creditable coverage under paragraph (d) of this section, the plan must provide the individual a written notice of the length of preexisting condition exclusion that remains after offsetting for prior creditable coverage. This individual notice is not required to identify any medical conditions specific to the individual that could be subject to the exclusion. A plan is not required to provide this notice if the plan does not impose any preexisting condition exclusion on the individual or if the plan's preexisting condition exclusion is completely offset by the individual's prior creditable coverage. (See 29 CFR 2590.701–3(e) and 45 CFR 146.111(e), which also impose this requirement on a health insurance issuer offering group health insurance coverage.)

(1) *Manner and timing*. The individual notice must be provided by the earliest date following a determination that the plan, acting in a reasonable and prompt fashion, can provide the notice.

(2) *Content*. A plan must disclose—

(i) Its determination of any preexisting condition exclusion period that applies to the individual (including the last day on which the preexisting condition exclusion applies);

(ii) The basis for such determination, including the source and substance of any information on which the plan relied;

(iii) An explanation of the individual's right to submit additional evidence of creditable coverage; and

(iv) A description of any applicable appeal procedures established by the plan.

(3) *Duplicate notices not required*. If a notice satisfying the requirements of this paragraph (e) is provided to an individual by another party, the plan's obligation to provide this individual notice of preexisting condition exclusion with respect to that individual is satisfied. (See 29 CFR 2590.701–3(e)(3) and 45 CFR 146.111(e)(3), which provide that the issuer's obligation is similarly satisfied.)

(4) *Examples*. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts*. A group health plan imposes a preexisting condition exclusion period of 12 months. After receiving the general notice of preexisting condition exclusion, Individual *G* presents a certificate of creditable coverage indicating 240 days of creditable coverage. Within seven days of receipt of the certificate, the plan determines that *G* is subject to a preexisting condition exclusion of 125 days, the last day of which is March 5. Five days later, the plan notifies *G* that, based on the certificate *G* submitted, *G* is subject to a preexisting condition exclusion period of 125 days, ending on March 5. The notice also explains the opportunity to submit additional evidence of creditable coverage and the plan's appeal procedures. The notice does not identify any of *G*'s medical conditions that could be subject to the exclusion.

(ii) *Conclusion*. In this *Example 1*, the plan satisfies the requirements of this paragraph (e).

Example 2. (i) *Facts*. Same facts as in *Example 1*, except that the plan determines that *G* has 430 days of creditable coverage based on *G*'s certificate indicating 430 days of creditable coverage under *G*'s prior plan.

(ii) *Conclusion*. In this *Example 2*, the plan is not required to notify *G* that *G* will not be subject to a preexisting condition exclusion.

(f) *Reconsideration*. Nothing in this section prevents a plan from modifying an initial determination of creditable coverage if it determines that the individual did not have the claimed creditable coverage, provided that—

(1) A notice of the new determination (consistent with the requirements of paragraph (e) of this section) is provided to the individual; and

(2) Until the notice of the new determination is provided, the plan, for purposes of approving access to medical services (such as a pre-surgery authorization), acts in a manner consistent with the initial determination.

[T.D. 9166, 69 FR 78746, Dec. 30, 2004]

§ 54.9801–4 Rules relating to creditable coverage.

(a) *General rules*—(1) *Creditable coverage*. For purposes of this section, except as provided in paragraph (a)(2) of this section, the term *creditable coverage* means coverage of an individual under any of the following:

(i) A group health plan as defined in § 54.9831–1(a).

(ii) Health insurance coverage as defined in § 54.9801–2 (whether or not the entity offering the coverage is subject to Chapter 100 of Subtitle K, and without regard to whether the coverage is offered in the group market, the individual market, or otherwise).

(iii) Part A or B of Title XVIII of the Social Security Act (Medicare).

(iv) Title XIX of the Social Security Act (Medicaid), other than coverage consisting solely of benefits under section 1928 of the Social Security Act (the program for distribution of pediatric vaccines).

(v) Title 10 U.S.C. Chapter 55 (medical and dental care for members and certain former members of the uniformed services, and for their dependents; for purposes of Title 10 U.S.C. Chapter 55, *uniformed services* means the armed forces and the Commissioned Corps of the National Oceanic and Atmospheric Administration and of the Public Health Service).

(vi) A medical care program of the Indian Health Service or of a tribal organization.

(vii) A State health benefits risk pool. For purposes of this section, a *State health benefits risk pool* means—

(A) An organization qualifying under section 501(c)(26);

(B) A qualified high risk pool described in section 2744(c)(2) of the PHS Act; or

(C) Any other arrangement sponsored by a State, the membership composition of which is specified by the State and which is established and maintained primarily to provide health coverage for individuals who are residents of such State and who, by reason of the existence or history of a medical condition—

(*1*) Are unable to acquire medical care coverage for such condition through insurance or from an HMO, or

(*2*) Are able to acquire such coverage only at a rate which is substantially in excess of the rate for such coverage through the membership organization.

(viii) A health plan offered under Title 5 U.S.C. Chapter 89 (the Federal Employees Health Benefits Program).

(ix) A public health plan. For purposes of this section, a public health plan means any plan established or maintained by a State, the U.S. government, a foreign country, or any political subdivision of a State, the U.S. government, or a foreign country that provides health coverage to individuals who are enrolled in the plan.

(x) A health benefit plan under section 5(e) of the Peace Corps Act (22 U.S.C. 2504(e)).

(xi) Title XXI of the Social Security Act (State Children's Health Insurance Program).

(2) *Excluded coverage.* Creditable coverage does not include coverage of solely excepted benefits (described in § 54.9831–1).

(3) *Methods of counting creditable coverage.* For purposes of reducing any preexisting condition exclusion period, as provided under § 54.9801–3(a)(2)(iii), the amount of an individual's creditable coverage generally is determined by using the standard method described in paragraph (b) of this section. A plan may use the alternative method under paragraph (c) of this section with respect to any or all of the categories of benefits described under paragraph (c)(3) of this section or may provide that a health insurance issuer offering health insurance coverage under the plan may use the alternative method of counting creditable coverage.

(b) *Standard method*—(1) *Specific benefits not considered.* Under the standard method, the amount of creditable coverage is determined without regard to the specific benefits included in the coverage.

(2) *Counting creditable coverage*—(i) *Based on days.* For purposes of reducing the preexisting condition exclusion period that applies to an individual, the amount of creditable coverage is determined by counting all the days on which the individual has one or more types of creditable coverage. Accordingly, if on a particular day an individual has creditable coverage from more than one source, all the creditable coverage on that day is counted as one day. Any days in a waiting period for coverage are not creditable coverage.

(ii) *Days not counted before significant break in coverage.* Days of creditable coverage that occur before a significant break in coverage are not required to be counted.

(iii) *Significant break in coverage defined*—A significant break in coverage means a period of 63 consecutive days during each of which an individual does not have any creditable coverage. (*See* section 731(b)(2)(iii) of ERISA and section 2723(b)(2)(iii) of the PHS Act, which exclude from preemption State insurance laws that require a break of more than 63 days before an individual has a significant break in coverage for purposes of State law.)

(iv) *Periods that toll a significant break.* Days in a waiting period and days in an affiliation period are not taken into account in determining whether a significant break in coverage has occurred. In addition, for an individual who elects COBRA continuation coverage during the second election period provided under the Trade Act of 2002, the days between the date the individual lost group health plan coverage and the first day of the second COBRA election period are not taken into account in determining whether a significant break in coverage has occurred.

(v) *Examples.* The rules of this paragraph (b)(2) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual *A* has creditable coverage under Employer *P*'s plan for 18 months before coverage ceases. *A* is provided a certificate of creditable coverage on *A*'s last day of coverage. Sixty-four days after the last date of coverage under *P*'s plan, *A* is hired by Employer *Q* and enrolls in *Q*'s group health plan. *Q*'s plan has a 12-month preexisting condition exclusion.

(ii) *Conclusion.* In this *Example 1*, *A* has a break in coverage of 63 days. Because *A*'s break in coverage is a significant break in coverage, *Q*'s plan may disregard *A*'s prior coverage and *A* may be subject to a 12-month preexisting condition exclusion.

Example 2. (i) *Facts.* Same facts as *Example 1*, except that *A* is hired by *Q* and enrolls in

Q's plan on the 63rd day after the last date of coverage under *P*'s plan.

(ii) *Conclusion*. In this *Example 2*, *A* has a break in coverage of 62 days. Because *A*'s break in coverage is not a significant break in coverage, *Q*'s plan must count *A*'s prior creditable coverage for purposes of reducing the plan's preexisting condition exclusion period that applies to *A*.

Example 3. (i) *Facts*. Same facts as *Example 1*, except that *Q*'s plan provides benefits through an insurance policy that, as required by applicable State insurance laws, defines a significant break in coverage as 90 days.

(ii) *Conclusion*. In this *Example 3*, under State law, the issuer that provides group health insurance coverage to *Q*'s plan must count *A*'s period of creditable coverage prior to the 63-day break. (However, if *Q*'s plan was a self-insured plan, the coverage would not be subject to State law. Therefore, the health coverage would not be governed by the longer break rules and *A*'s previous health coverage could be disregarded.)

Example 4. [Reserved]

Example 5. (i) *Facts*. Individual *C* has creditable coverage under Employer *S*'s plan for 200 days before coverage ceases. *C* is provided a certificate of creditable coverage on *C*'s last day of coverage. *C* then does not have any creditable coverage for 51 days before being hired by Employer *T*. *T*'s plan has a 3-month waiting period. *C* works for *T* for 2 months and then terminates employment. Eleven days after terminating employment with *T*, *C* begins working for Employer *U*. *U*'s plan has no waiting period, but has a 6-month preexisting condition exclusion.

(ii) *Conclusion*. In this *Example 5*, *C* does not have a significant break in coverage because, after disregarding the waiting period under *T*'s plan, *C* had only a 62-day break in coverage (51 days plus 11 days). Accordingly, *C* has 200 days of creditable coverage, and *U*'s plan may not apply its 6-month preexisting condition exclusion with respect to *C*.

Example 6. [Reserved]

Example 7. (i) *Facts*. Individual *E* has creditable coverage under Employer *X*'s plan. *E* is provided a certificate of creditable coverage on *E*'s last day of coverage. On the 63rd day without coverage, *E* submits a substantially complete application for a health insurance policy in the individual market. *E*'s application is accepted and coverage is made effective 10 days later.

(ii) *Conclusion*. In this *Example 7*, because *E* applied for the policy before the end of the 63rd day, the period between the date of application and the first day of coverage is a waiting period and no significant break in coverage occurred even though the actual period without coverage was 73 days.

Example 8. (i) *Facts*. Same facts as *Example 7*, except that *E*'s application for a policy in the individual market is denied.

(ii) *Conclusion*. In this *Example 8*, even though *E* did not obtain coverage following application, the period between the date of application and the date the coverage was denied is a waiting period. However, to avoid a significant break in coverage, no later than the day after the application for the policy is denied *E* would need to do one of the following: submit a substantially complete application for a different individual market policy; obtain coverage in the group market; or be in a waiting period for coverage in the group market.

(vi) *Other permissible counting methods*—(a) *Rule*. Notwithstanding any other provisions of this paragraph (b)(2), for purposes of reducing a preexisting condition exclusion period (but not for purposes of issuing a certificate under § 54.9801–5), a group health plan may determine the amount of creditable coverage in any other manner that is at least as favorable to the individual as the method set forth in this paragraph (b)(2), subject to the requirements of other applicable law.

(B) *Example*. The rule of this paragraph (b)(2)(vi) is illustrated by the following example:

Example. (i) *Facts*. Individual *F* has coverage under Group Health Plan *Y* from January 3, 1997 through March 25, 1997. *F* then becomes covered by Group Health Plan *Z*. *F's* enrollment date in Plan *Z* is May 1, 1997. Plan *Z* has a 12-month preexisting condition exclusion.

(ii) *Conclusion*. In this *Example*, Plan *Z* may determine, in accordance with the rules prescribed in paragraphs (b)(2)(i), (ii), and (iii) of this section, that *F* has 82 days of creditable coverage (29 days in January, 28 days in February, and 25 days in March). Thus, the preexisting condition exclusion will no longer apply to *F* on February 8, 1998 (82 days before the 12-month anniversary of *F*'s enrollment (May 1)). For administrative convenience, however, Plan *Z* may consider that the preexisting condition exclusion will no longer apply to *F* on the first day of the month (February 1).

(c) *Alternative method*—(1) *Specific benefits considered*. Under the alternative method, a group health plan determines the amount of creditable coverage based on coverage within any category of benefits described in paragraph (c)(3) of this section and not based on coverage for any other benefits. The plan may use the alternative method for any or all of the categories. The plan may apply a different preexisting condition exclusion period

with respect to each category (and may apply a different preexisting condition exclusion period for benefits that are not within any category). The creditable coverage determined for a category of benefits applies only for purposes of reducing the preexisting condition exclusion period with respect to that category. An individual's creditable coverage for benefits that are not within any category for which the alternative method is being used is determined under the standard method of paragraph (b) of this section.

(2) *Uniform application*. A plan using the alternative method is required to apply it uniformly to all participants and beneficiaries under the plan. A plan that provides benefits (in part or in whole) through one or more policies or contracts of insurance will not fail the uniform application requirement of this paragraph (c)(2) if the alternative method is used (or not used) separately with respect to participants and beneficiaries under any policy or contact, provided that the alternative method is applied uniformly with respect to all coverage under that policy or contract. The use of the alternative method is required to be set forth in the plan.

(3) *Categories of benefits*. The alternative method for counting creditable coverage may be used for coverage for the following categories of benefits—

(i) Mental health;

(ii) Substance abuse treatment;

(iii) Prescription drugs;

(iv) Dental care; or

(v) Vision care.

(4) *Plan notice*. If the alternative method is used, the plan is required to—

(i) State prominently that the plan is using the alternative method of counting creditable coverage in disclosure statements concerning the plan, and state this to each enrollee at the time of enrollment under the plan; and

(ii) Include in these statements a description of the effect of using the alternative method, including an identification of the categories used.

(5) *Disclosure of information on previous benefits*. See § 54.9801–5(b) for special rules concerning disclosure of coverage to a plan (or issuer) using the alternative method of counting creditable coverage under this paragraph (c).

(6) *Counting creditable coverage*—(i) *In general*. Under the alternative method, the group health plan counts creditable coverage within a category if any level of benefits is provided within the category. Coverage under a reimbursement account or arrangement, such as a flexible spending arrangement (as defined in section 106(c)(2)), does not constitute coverage within any category.

(ii) *Special rules*. In counting an individual's creditable coverage under the alternative method, the group health plan first determines the amount of the individual's creditable coverage that may be counted under paragraph (b) of this section, up to a total of 365 days of the most recent creditable coverage (546 days for a late enrollee). The period over which this creditable coverage is determined is referred to as the determination period. Then, for the category specified under the alternative method, the plan counts within the category all days of coverage that occurred during the determination period (whether or not a significant break in coverage for that category occurs), and reduces the individual's preexisting condition exclusion period for that category by that number of days. The plan may determine the amount of creditable coverage in any other reasonable manner, uniformly applied, that is at least as favorable to the individual.

(iii) *Example*. The rules of this paragraph (c)(6) are illustrated by the following example:

Example. (i) *Facts*. Individual *D* enrolls in Employer *V*'s plan on January 1, 2001. Coverage under the plan includes prescription drug benefits. On April 1, 2001, the plan ceases providing prescription drug benefits. *D*'s employment with Employer *V* ends on January 1, 2002, after *D* was covered under Employer *V*'s group health plan for 365 days. *D* enrolls in Employer *Y*'s plan on February 1, 2002 (*D*'s enrollment date). Employer *Y*'s plan uses the alternative method of counting creditable coverage and imposes a 12-month preexisting condition exclusion on prescription drug benefits.

(ii) *Conclusion*. In this *Example*, Employer *Y*'s plan may impose a 275-day preexisting condition exclusion with respect to *D* for prescription drug benefits because *D* had 90

days of creditable coverage relating to prescription drug benefits within *D*'s determination period.

[T.D. 9166, 69 FR 78746, Dec. 30, 2004]

§ 54.9801–5 Evidence of creditable coverage.

(a) *Certificate of creditable coverage*—(1) *Entities required to provide certificate*—(i) *In general.* A group health plan is required to furnish certificates of creditable coverage in accordance with this paragraph (a). (See section 701(e) of ERISA and section 2701(e) of the PHS Act, under which this obligation is also imposed on each health insurance issuer offering group health insurance coverage under the plan.)

(ii) *Duplicate certificates not required.* An entity required to provide a certificate under this paragraph (a) with respect to an individual satisfies that requirement if another party provides the certificate, but only to the extent that the certificate contains the information required in paragraph (a)(3) of this section. For example, a group health plan is deemed to have satisfied the certification requirement with respect to a participant or beneficiary if any other entity actually provides a certificate that includes the information required under paragraph (a)(3) of this section with respect to the participant or beneficiary.

(iii) *Special rule for group health plans.* To the extent coverage under a plan consists of group health insurance coverage, the plan satisfies the certification requirements under this paragraph (a) if any issuer offering the coverage is required to provide the certificates pursuant to an agreement between the plan and the issuer. For example, if there is an agreement between an issuer and an employer sponsoring a plan under which the issuer agrees to provide certificates for individuals covered under the plan, and the issuer fails to provide a certificate to an individual when the plan would have been required to provide one under this paragraph (a), then the plan does not violate the certification requirements of this paragraph (a) (though the issuer would have violated the certification requirements pursuant to section 701(e) of ERISA and section 2701(e) of the PHS Act).

(iv) *Special rules relating to issuers providing coverage under a plan*—(A)(1) *Responsibility of issuer for coverage period.* See 29 CFR 2590.701–5 and 45 CFR 146.115, under which an issuer is not required to provide information regarding coverage provided to an individual by another party.

(*2*) *Example.* The rule referenced by this paragraph (a)(1)(iv)(A) is illustrated by the following example:

Example. (i) *Facts.* A plan offers coverage with an HMO option from one issuer and an indemnity option from a different issuer. The HMO has not entered into an agreement with the plan to provide certificates as permitted under paragraph (a)(1)(iii) of this section.

(ii) *Conclusion.* In this *Example,* if an employee switches from the indemnity option to the HMO option and later ceases to be covered under the plan, any certificate provided by the HMO is not required to provide information regarding the employee's coverage under the indemnity option.

(B)(*1*) *Cessation of issuer coverage prior to cessation of coverage under a plan.* If an individual's coverage under an issuer's policy or contract ceases before the individual's coverage under the plan ceases, the issuer is required (under section 701(e) of ERISA and section 2701(e) of the PHS Act) to provide sufficient information to the plan (or to another party designated by the plan) to enable the plan (or other party), after cessation of the individual's coverage under the plan, to provide a certificate that reflects the period of coverage under the policy or contract. By providing that information to the plan, the issuer satisfies its obligation to provide an automatic certificate for that period of creditable coverage with respect to the individual under paragraph (a)(2)(ii) of this section. The issuer, however, must still provide a certificate upon request as required under paragraph (a)(2)(iii) of this section. In addition, the issuer is required to cooperate with the plan in responding to any request made under paragraph (b)(2) of this section (relating to the alternative method of counting creditable coverage). Moreover, if the individual's coverage under the plan ceases at the time the individual's coverage under the issuer's policy or contract ceases, the issuer must still provide an automatic certificate under

paragraph (a)(2)(ii) of this section. If an individual's coverage under an issuer's policy or contract ceases on the effective date for changing enrollment options under the plan, the issuer may presume (absent information to the contrary) that the individual's coverage under the plan continues. Therefore, the issuer is required to provide information to the plan in accordance with this paragraph (a)(1)(iv)(B)(*1*) (and is not required to provide an automatic certificate under paragraph (a)(2)(ii) of this section).

(*2*) *Example*. The rule of this paragraph (a)(1)(iv)(B) is illustrated by the following example:

Example. (i) *Facts*. A group health plan provides coverage under an HMO option and an indemnity option through different issuers, and only allows employees to switch on each January 1. Neither the HMO nor the indemnity issuer has entered into an agreement with the plan to provide certificates as permitted under paragraph (a)(1)(iii) of this section.

(ii) *Conclusion*. In this *Example*, if an employee switches from the indemnity option to the HMO option on January 1, the indemnity issuer must provide the plan (or a person designated by the plan) with appropriate information with respect to the individual's coverage with the indemnity issuer. However, if the individual's coverage with the indemnity issuer ceases at a date other than January 1, the issuer is instead required to provide the individual with an automatic certificate.

(2) *Individuals for whom certificate must be provided; timing of issuance*—(i) *Individuals*. A certificate must be provided, without charge, for participants or dependents who are or were covered under a group health plan upon the occurrence of any of the events described in paragraph (a)(2)(ii) or (iii) of this section.

(ii) *Issuance of automatic certificates*. The certificates described in this paragraph (a)(2)(ii) are referred to as automatic certificates.

(A) *Qualified beneficiaries upon a qualifying event*. In the case of an individual who is a qualified beneficiary (as defined in section 4980B(g)(3)) entitled to elect COBRA continuation coverage, an automatic certificate is required to be provided at the time the individual would lose coverage under the plan in the absence of COBRA continuation coverage or alternative coverage elected instead of COBRA continuation coverage. A plan satisfies this requirement if it provides the automatic certificate no later than the time a notice is required to be furnished for a qualifying event under section 4980B(f)(6) (relating to notices required under COBRA).

(B) *Other individuals when coverage ceases*. In the case of an individual who is not a qualified beneficiary entitled to elect COBRA continuation coverage, an automatic certificate must be provided at the time the individual ceases to be covered under the plan. A plan satisfies the requirement to provide an automatic certificate at the time the individual ceases to be covered if it provides the automatic certificate within a reasonable time after coverage ceases (or after the expiration of any grace period for nonpayment of premiums).

(*1*) The cessation of temporary continuation coverage (TCC) under Title 5 U.S.C. Chapter 89 (the Federal Employees Health Benefit Program) is a cessation of coverage upon which an automatic certificate must be provided.

(*2*) In the case of an individual who is entitled to elect to continue coverage under a State program similar to COBRA and who receives the automatic certificate not later than the time a notice is required to be furnished under the State program, the certificate is deemed to be provided within a reasonable time after coverage ceases under the plan.

(*3*) If an individual's coverage ceases due to the operation of a lifetime limit on all benefits, coverage is considered to cease for purposes of this paragraph (a)(2)(ii)(B) on the earliest date that a claim is denied due to the operation of the lifetime limit.

(C) *Qualified beneficiaries when COBRA ceases*. In the case of an individual who is a qualified beneficiary and has elected COBRA continuation coverage (or whose coverage has continued after the individual became entitled to elect COBRA continuation coverage), an automatic certificate is to be provided at the time the individual' s coverage under the plan ceases. A plan satisfies this requirement if it provides the automatic certificate within a reasonable time after

coverage ceases (or after the expiration of any grace period for nonpayment of premiums). An automatic certificate is required to be provided to such an individual regardless of whether the individual has previously received an automatic certificate under paragraph (a)(2)(ii)(A) of this section.

(iii) *Any individual upon request.* A certificate must be provided in response to a request made by, or on behalf of, an individual at any time while the individual is covered under a plan and up to 24 months after coverage ceases. Thus, for example, a plan in which an individual enrolls may, if authorized by the individual, request a certificate of the individual's creditable coverage on behalf of the individual from a plan in which the individual was formerly enrolled. After the request is received, a plan or issuer is required to provide the certificate by the earliest date that the plan, acting in a reasonable and prompt fashion, can provide the certificate. A certificate is required to be provided under this paragraph (a)(2)(iii) even if the individual has previously received a certificate under this paragraph (a)(2)(iii) or an automatic certificate under paragraph (a)(2)(ii) of this section.

(iv) *Examples.* The rules of this paragraph (a)(2) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual *A* terminates employment with Employer *Q*. *A* is a qualified beneficiary entitled to elect COBRA continuation coverage under Employer *Q's* group health plan. A notice of the rights provided under COBRA is typically furnished to qualified beneficiaries under the plan within 10 days after a covered employee terminates employment.

(ii) *Conclusion.* In this *Example 1*, the automatic certificate may be provided at the same time that *A* is provided the COBRA notice.

Example 2. (i) *Facts.* Same facts as *Example 1*, except that the automatic certificate for *A* is not completed by the time the COBRA notice is furnished to *A*.

(ii) *Conclusion.* In this *Example 2*, the automatic certificate may be provided after the COBRA notice but must be provided within the period permitted by law for the delivery of notices under COBRA.

Example 3. (i) *Facts.* Employer *R* maintains an insured group health plan. *R* has never had 20 employees and thus *R's* plan is not subject to the COBRA continuation provisions. However, *R* is in a State that has a State program similar to COBRA. *B* terminates employment with *R* and loses coverage under *R's* plan.

(ii) *Conclusion.* In this *Example 3*, the automatic certificate must be provided not later than the time a notice is required to be furnished under the State program.

Example 4. (i) *Facts.* Individual *C* terminates employment with Employer *S* and receives both a notice of *C's* rights under COBRA and an automatic certificate. *C* elects COBRA continuation coverage under Employer *S's* group health plan. After four months of COBRA continuation coverage and the expiration of a 30-day grace period, *S's* group health plan determines that *C's* COBRA continuation coverage has ceased due to a failure to make a timely payment for continuation coverage.

(ii) *Conclusion.* In this *Example 4*, the plan must provide an updated automatic certificate to *C* within a reasonable time after the end of the grace period.

Example 5. (i) *Facts.* Individual *D* is currently covered under the group health plan of Employer *T*. *D* requests a certificate, as permitted under paragraph (a)(2)(iii) of this section. Under the procedure for *T's* plan, certificates are mailed (by first class mail) 7 business days following receipt of the request. This date reflects the earliest date that the plan, acting in a reasonable and prompt fashion, can provide certificates.

(ii) *Conclusion.* In this *Example 5*, the plan's procedure satisfies paragraph (a)(2)(iii) of this section.

(3) *Form and content of certificate*—(i) *Written certificate*—(A) *In general.* Except as provided in paragraph (a)(3)(i)(B) of this section, the certificate must be provided in writing (including any form approved by the Secretary as a writing).

(B) *Other permissible forms.* No written certificate is required to be provided under this paragraph (a) with respect to a particular event described in paragraph (a)(2)(ii) or (iii) of this section, if—

(*1*) An individual who is entitled to receive the certificate requests that the certificate be sent to another plan or issuer instead of to the individual;

(*2*) The plan or issuer that would otherwise receive the certificate agrees to accept the information in this paragraph (a)(3) through means other than a written certificate (such as by telephone); and

(*3*) The receiving plan or issuer receives the information from the sending plan or issuer through such means

within the time required under paragraph (a)(2) of this section.

(ii) *Required information*. The certificate must include the following—

(A) The date the certificate is issued;

(B) The name of the group health plan that provided the coverage described in the certificate;

(C) The name of the participant or dependent with respect to whom the certificate applies, and any other information necessary for the plan providing the coverage specified in the certificate to identify the individual, such as the individual's identification number under the plan and the name of the participant if the certificate is for (or includes) a dependent;

(D) The name, address, and telephone number of the plan administrator or issuer required to provide the certificate;

(E) The telephone number to call for further information regarding the certificate (if different from paragraph (a)(3)(ii)(D) of this section);

(F) Either—

(*1*) A statement that an individual has at least 18 months (for this purpose, 546 days is deemed to be 18 months) of creditable coverage, disregarding days of creditable coverage before a significant break in coverage, or

(*2*) The date any waiting period (and affiliation period, if applicable) began and the date creditable coverage began;

(G) The date creditable coverage ended, unless the certificate indicates that creditable coverage is continuing as of the date of the certificate; and

(H) An educational statement regarding HIPAA, which explains:

(*1*) The restrictions on the ability of a plan or issuer to impose a preexisting condition exclusion (including an individual's ability to reduce a preexisting condition exclusion by creditable coverage);

(*2*) Special enrollment rights;

(*3*) The prohibitions against discrimination based on any health factor;

(*4*) The right to individual health coverage;

(*5*) The fact that State law may require issuers to provide additional protections to individuals in that State; and

(*6*) Where to get more information.

(iii) *Periods of coverage under the certificate*. If an automatic certificate is provided pursuant to paragraph (a)(2)(ii) of this section, the period that must be included on the certificate is the last period of continuous coverage ending on the date coverage ceased. If an individual requests a certificate pursuant to paragraph (a)(2)(iii) of this section, the certificate provided must include each period of continuous coverage ending within the 24-month period ending on the date of the request (or continuing on the date of the request). A separate certificate may be provided for each such period of continuous coverage.

(iv) *Combining information for families*. A certificate may provide information with respect to both a participant and the participant's dependents if the information is identical for each individual. If the information is not identical, certificates may be provided on one form if the form provides all the required information for each individual and separately states the information that is not identical.

(v) *Model certificate*. The requirements of paragraph (a)(3)(ii) of this section are satisfied if the plan provides a certificate in accordance with a model certificate authorized by the Secretary.

(vi) *Excepted benefits; categories of benefits*. No certificate is required to be furnished with respect to excepted benefits described in § 54.9831–1(c). In addition, the information in the certificate regarding coverage is not required to specify categories of benefits described in § 54.9801–4(c) (relating to the alternative method of counting creditable coverage). However, if excepted benefits are provided concurrently with other creditable coverage (so that the coverage does not consist solely of excepted benefits), information concerning the benefits may be required to be disclosed under paragraph (b) of this section.

(4) *Procedures*—(i) *Method of delivery*. The certificate is required to be provided to each individual described in paragraph (a)(2) of this section or an entity requesting the certificate on behalf of the individual. The certificate may be provided by first-class mail. If

the certificate or certificates are provided to the participant and the participant's spouse at the participant's last known address, then the requirements of this paragraph (a)(4) are satisfied with respect to all individuals residing at that address. If a dependent's last known address is different than the participant's last known address, a separate certificate is required to be provided to the dependent at the dependent's last known address. If separate certificates are being provided by mail to individuals who reside at the same address, separate mailings of each certificate are not required.

(ii) *Procedure for requesting certificates.* A plan or issuer must establish a written procedure for individuals to request and receive certificates pursuant to paragraph (a)(2)(iii) of this section. The written procedure must include all contact information necessary to request a certificate (such as name and phone number or address).

(iii) *Designated recipients.* If an automatic certificate is required to be provided under paragraph (a)(2)(ii) of this section, and the individual entitled to receive the certificate designates another individual or entity to receive the certificate, the plan or issuer responsible for providing the certificate is permitted to provide the certificate to the designated individual or entity. If a certificate is required to be provided upon request under paragraph (a)(2)(iii) of this section and the individual entitled to receive the certificate designates another individual or entity to receive the certificate, the plan or issuer responsible for providing the certificate is required to provide the certificate to the designated individual or entity.

(5) *Special rules concerning dependent coverage*—(i)(A) *Reasonable efforts.* A plan is required to use reasonable efforts to determine any information needed for a certificate relating to dependent coverage. In any case in which an automatic certificate is required to be furnished with respect to a dependent under paragraph (a)(2)(ii) of this section, no individual certificate is required to be furnished until the plan knows (or making reasonable efforts should know) of the dependent's cessation of coverage under the plan.

(B) *Example.* The rules of this paragraph (a)(5)(i) are illustrated by the following example:

Example. (i) *Facts.* A group health plan covers employees and their dependents. The plan annually requests all employees to provide updated information regarding dependents, including the specific date on which an employee has a new dependent or on which a person ceases to be a dependent of the employee.

(ii) *Conclusion.* In this *Example,* the plan has satisfied the standard in this paragraph (a)(5)(i) of this section that it make reasonable efforts to determine the cessation of dependents' coverage and the related dependent coverage information.

(ii) *Special rules for demonstrating coverage.* If a certificate furnished by a plan or issuer does not provide the name of any dependent covered by the certificate, the procedures described in paragraph (c)(5) of this section may be used to demonstrate dependent status. In addition, these procedures may be used to demonstrate that a child was covered under any creditable coverage within 30 days after birth, adoption, or placement for adoption. See also § 54.9801–3(b), under which such a child cannot be subject to a preexisting condition exclusion.

(6) *Special certification rules for entities not subject to Chapter 100 of Subtitle K*—(i) *Issuers.* For rules requiring that issuers in the group and individual markets provide certificates consistent with the rules in this section, see section 701(e) of ERISA and sections 2701(e), 2721(b)(1)(B), and 2743 of the PHS Act.

(ii) *Other entities.* For special rules requiring that certain other entities not subject to Chapter 100 of Subtitle K provide certificates consistent with the rules in this section, see section 2791(a)(3) of the PHS Act applicable to entities described in sections 2701(c)(1)(C), (D), (E), and (F) of the PHS Act (relating to Medicare, Medicaid, TRICARE, and Indian Health Service), section 2721(b)(1)(A) of the PHS Act applicable to nonfederal governmental plans generally, and section 2721(b)(2)(C)(ii) of the PHS Act applicable to nonfederal governmental plans that elect to be excluded from the requirements of Subparts 1 through 3 of Part A of Title XXVII of the PHS Act.

(b) *Disclosure of coverage to a plan or issuer using the alternative method of counting creditable coverage*—(1) *In general.* After an individual provides a certificate of creditable coverage to a plan (or issuer) using the alternative method under §54.9801–4(c), that plan (or issuer) (requesting entity) must request that the entity that issued the certificate (prior entity) disclose the information set forth in paragraph (b)(2) of this section. The prior entity is required to disclose this information promptly.

(2) *Information to be disclosed.* The prior entity is required to identify to the requesting entity the categories of benefits with respect to which the requesting entity is using the alternative method of counting creditable coverage, and the requesting entity may identify specific information that the requesting entity reasonably needs in order to determine the individual's creditable coverage with respect to any such category.

(3) *Charge for providing information.* The prior entity may charge the requesting entity for the reasonable cost of disclosing such information.

(c) *Ability of an individual to demonstrate creditable coverage and waiting period information*—(1) *Purpose.* The rules in this paragraph (c) implement section 9801(c)(4), which permits individuals to demonstrate the duration of creditable coverage through means other than certificates, and section 9801(e)(3), which requires the Secretary to establish rules designed to prevent an individual's subsequent coverage under a group health plan or health insurance coverage from being adversely affected by an entity's failure to provide a certificate with respect to that individual.

(2) *In general.* If the accuracy of a certificate is contested or a certificate is unavailable when needed by an individual, the individual has the right to demonstrate creditable coverage (and waiting or affiliation periods) through the presentation of documents or other means. For example, the individual may make such a demonstration when—

(i) An entity has failed to provide a certificate within the required time;

(ii) The individual has creditable coverage provided by an entity that is not required to provide a certificate of the coverage pursuant to paragraph (a) of this section;

(iii) The individual has an urgent medical condition that necessitates a determination before the individual can deliver a certificate to the plan; or

(iv) The individual lost a certificate that the individual had previously received and is unable to obtain another certificate.

(3) *Evidence of creditable coverage*—(i) *Consideration of evidence*—(A) A plan is required to take into account all information that it obtains or that is presented on behalf of an individual to make a determination, based on the relevant facts and circumstances, whether an individual has creditable coverage. A plan shall treat the individual as having furnished a certificate under paragraph (a) of this section if—

(*1*) The individual attests to the period of creditable coverage;

(*2*) The individual also presents relevant corroborating evidence of some creditable coverage during the period; and

(*3*) The individual cooperates with the plan's efforts to verify the individual's coverage.

(B) For purposes of this paragraph (c)(3)(i), cooperation includes providing (upon the plan's or issuer's request) a written authorization for the plan to request a certificate on behalf of the individual, and cooperating in efforts to determine the validity of the corroborating evidence and the dates of creditable coverage. While a plan may refuse to credit coverage where the individual fails to cooperate with the plan's or issuer's efforts to verify coverage, the plan may not consider an individual's inability to obtain a certificate to be evidence of the absence of creditable coverage.

(ii) *Documents.* Documents that corroborate creditable coverage (and waiting or affiliation periods) include explanations of benefits (EOBs) or other correspondence from a plan or issuer indicating coverage, pay stubs showing a payroll deduction for health coverage, a health insurance identification card, a certificate of coverage under a

group health policy, records from medical care providers indicating health coverage, third party statements verifying periods of coverage, and any other relevant documents that evidence periods of health coverage.

(iii) *Other evidence.* Creditable coverage (and waiting or affiliation periods) may also be corroborated through means other than documentation, such as by a telephone call from the plan or provider to a third party verifying creditable coverage.

(iv) *Example.* The rules of this paragraph (c)(3) are illustrated by the following example:

Example. (i) *Facts.* Individual *F* terminates employment with Employer *W* and, a month later, is hired by Employer *X*. *X*'s group health plan imposes a preexisting condition exclusion of 12 months on new enrollees under the plan and uses the standard method of determining creditable coverage. *F* fails to receive a certificate of prior coverage from the self-insured group health plan maintained by *F*'s prior employer, *W*, and requests a certificate. However, *F* (and *X*'s plan, on *F*'s behalf and with *F*'s cooperation) is unable to obtain a certificate from *W*'s plan. *F* attests that, to the best of *F*'s knowledge, *F* had at least 12 months of continuous coverage under *W*'s plan, and that the coverage ended no earlier than *F*'s termination of employment from *W*. In addition, *F* presents evidence of coverage, such as an explanation of benefits for a claim that was made during the relevant period.

(ii) *Conclusion.* In this *Example*, based solely on these facts, *F* has demonstrated creditable coverage for the 12 months of coverage under *W*'s plan in the same manner as if *F* had presented a written certificate of creditable coverage.

(4) *Demonstrating categories of creditable coverage.* Procedures similar to those described in this paragraph (c) apply in order to determine the duration of an individual's creditable coverage with respect to any category under paragraph (b) of this section (relating to determining creditable coverage under the alternative method).

(5) *Demonstrating dependent status.* If, in the course of providing evidence (including a certificate) of creditable coverage, an individual is required to demonstrate dependent status, the group health plan or issuer is required to treat the individual as having furnished a certificate showing the dependent status if the individual attests to such dependency and the period of such status and the individual cooperates with the plan's or issuer's efforts to verify the dependent status.

[T.D. 9166, 69 FR 78746, Dec. 30, 2004]

§ 54.9801–6 Special enrollment periods.

(a) *Special enrollment for certain individuals who lose coverage*—(1) *In general.* A group health plan is required to permit current employees and dependents (as defined in § 54.9801–2) who are described in paragraph (a)(2) of this section to enroll for coverage under the terms of the plan if the conditions in paragraph (a)(3) of this section are satisfied. The special enrollment rights under this paragraph (a) apply without regard to the dates on which an individual would otherwise be able to enroll under the plan. (See section 701(f)(1) of ERISA and section 2701(f)(1) of the PHS Act, under which this obligation is also imposed on a health insurance issuer offering group health insurance coverage.)

(2) *Individuals eligible for special enrollment*—(i) *When employee loses coverage.* A current employee and any dependents (including the employee's spouse) each are eligible for special enrollment in any benefit package under the plan (subject to plan eligibility rules conditioning dependent enrollment on enrollment of the employee) if—

(A) The employee and the dependents are otherwise eligible to enroll in the benefit package;

(B) When coverage under the plan was previously offered, the employee had coverage under any group health plan or health insurance coverage; and

(C) The employee satisfies the conditions of paragraph (a)(3)(i), (ii), or (iii) of this section and, if applicable, paragraph (a)(3)(iv) of this section.

(ii) *When dependent loses coverage*—(A) A dependent of a current employee (including the employee's spouse) and the employee each are eligible for special enrollment in any benefit package under the plan (subject to plan eligibility rules conditioning dependent enrollment on enrollment of the employee) if—

(*1*) The dependent and the employee are otherwise eligible to enroll in the benefit package;

(*2*) When coverage under the plan was previously offered, the dependent had coverage under any group health plan or health insurance coverage; and

(*3*) The dependent satisfies the conditions of paragraph (a)(3)(i), (ii), or (iii) of this section and, if applicable, paragraph (a)(3)(iv) of this section.

(B) However, the plan is not required to enroll any other dependent unless that dependent satisfies the criteria of this paragraph (a)(2)(ii), or the employee satisfies the criteria of paragraph (a)(2)(i) of this section.

(iii) *Examples*. The rules of this paragraph (a)(2) are illustrated by the following examples:

Example 1. (i) *Facts*. Individual *A* works for Employer *X*. *A*, *A*'s spouse, and *A*'s dependent children are eligible but not enrolled for coverage under X's group health plan. *A*'s spouse works for Employer *Y* and at the time coverage was offered under X's plan, *A* was enrolled in coverage under *Y*'s plan. Then, *A* loses eligibility for coverage under *Y*'s plan.

(ii) *Conclusion*. In this *Example 1*, because *A* satisfies the conditions for special enrollment under paragraph (a)(2)(i) of this section, *A*, *A*'s spouse, and *A*'s dependent children are eligible for special enrollment under *X*'s plan.

Example 2. (i) *Facts*. Individual *A* and *A*'s spouse are eligible but not enrolled for coverage under Group Health Plan *P* maintained by *A*'s employer. When *A* was first presented with an opportunity to enroll *A* and *A*'s spouse, they did not have other coverage. Later, *A* and *A*'s spouse enroll in Group Health Plan *Q* maintained by the employer of *A*'s spouse. During a subsequent open enrollment period in *P*, *A* and *A*'s spouse did not enroll because of their coverage under *Q*. They then lose eligibility for coverage under *Q*.

(ii) *Conclusion*. In this *Example 2*, because *A* and *A*'s spouse were covered under *Q* when they did not enroll in *P* during open enrollment, they satisfy the conditions for special enrollment under paragraphs (a)(2)(i) and (ii) of this section. Consequently, *A* and *A*'s spouse are eligible for special enrollment under *P*.

Example 3. (i) *Facts*. Individual *B* works for Employer *X*. *B* and *B*'s spouse are eligible but not enrolled for coverage under *X*'s group health plan. *B*'s spouse works for Employer *Y* and at the time coverage was offered under *X*'s plan, *B*'s spouse was enrolled in self-only coverage under *Y*'s group health plan. Then, *B*'s spouse loses eligibility for coverage under *Y*'s plan.

(ii) *Conclusion*. In this *Example 3*, because *B*'s spouse satisfies the conditions for special enrollment under paragraph (a)(2)(ii) of this section, both *B* and *B*'s spouse are eligible for special enrollment under *X*'s plan.

Example 4. (i) *Facts*. Individual *A* works for Employer *X*. *X* maintains a group health plan with two benefit packages—an HMO option and an indemnity option. Self-only and family coverage are available under both options. *A* enrolls for self-only coverage in the HMO option. *A*'s spouse works for Employer *Y* and was enrolled for self-only coverage under *Y*'s plan at the time coverage was offered under *X*'s plan. Then, *A*'s spouse loses coverage under *Y*'s plan. *A* requests special enrollment for *A* and *A*'s spouse under the plan's indemnity option.

(ii) *Conclusion*. In this *Example 4*, because *A*'s spouse satisfies the conditions for special enrollment under paragraph (a)(2)(ii) of this section, both *A* and *A*'s spouse can enroll in either benefit package under *X*'s plan. Therefore, if *A* requests enrollment in accordance with the requirements of this section, the plan must allow *A* and *A*'s spouse to enroll in the indemnity option.

(3) *Conditions for special enrollment*—(i) *Loss of eligibility for coverage*. In the case of an employee or dependent who has coverage that is not COBRA continuation coverage, the conditions of this paragraph (a)(3)(i) are satisfied at the time the coverage is terminated as a result of loss of eligibility (regardless of whether the individual is eligible for or elects COBRA continuation coverage). Loss of eligibility under this paragraph (a)(3)(i) does not include a loss due to the failure of the employee or dependent to pay premiums on a timely basis or termination of coverage for cause (such as making a fraudulent claim or an intentional misrepresentation of a material fact in connection with the plan). Loss of eligibility for coverage under this paragraph (a)(3)(i) includes (but is not limited to)—

(A) Loss of eligibility for coverage as a result of legal separation, divorce, cessation of dependent status (such as attaining the maximum age to be eligible as a dependent child under the plan), death of an employee, termination of employment, reduction in the number of hours of employment, and any loss of eligibility for coverage after a period that is measured by reference to any of the foregoing;

(B) In the case of coverage offered through an HMO, or other arrangement, in the individual market that does not provide benefits to individuals

who no longer reside, live, or work in a service area, loss of coverage because an individual no longer resides, lives, or works in the service area (whether or not within the choice of the individual);

(C) In the case of coverage offered through an HMO, or other arrangement, in the group market that does not provide benefits to individuals who no longer reside, live, or work in a service area, loss of coverage because an individual no longer resides, lives, or works in the service area (whether or not within the choice of the individual), and no other benefit package is available to the individual;

(D) A situation in which an individual incurs a claim that would meet or exceed a lifetime limit on all benefits; and

(E) A situation in which a plan no longer offers any benefits to the class of similarly situated individuals (as described in § 54.9802–1(d)) that includes the individual.

(ii) *Termination of employer contributions.* In the case of an employee or dependent who has coverage that is not COBRA continuation coverage, the conditions of this paragraph (a)(3)(ii) are satisfied at the time employer contributions towards the employee's or dependent's coverage terminate. Employer contributions include contributions by any current or former employer that was contributing to coverage for the employee or dependent.

(iii) *Exhaustion of COBRA continuation coverage.* In the case of an employee or dependent who has coverage that is COBRA continuation coverage, the conditions of this paragraph (a)(3)(iii) are satisfied at the time the COBRA continuation coverage is exhausted. For purposes of this paragraph (a)(3)(iii), an individual who satisfies the conditions for special enrollment of paragraph (a)(3)(i) of this section, does not enroll, and instead elects and exhausts COBRA continuation coverage satisfies the conditions of this paragraph (a)(3)(iii). (*Exhaustion of COBRA continuation coverage* is defined in § 54.9801–2.)

(iv) *Written statement.* A plan may require an employee declining coverage (for the employee or any dependent of the employee) to state in writing whether the coverage is being declined due to other health coverage only if, at or before the time the employee declines coverage, the employee is provided with notice of the requirement to provide the statement (and the consequences of the employee's failure to provide the statement). If a plan requires such a statement, and an employee does not provide it, the plan is not required to provide special enrollment to the employee or any dependent of the employee under this paragraph (a)(3). A plan must treat an employee as having satisfied the plan requirement permitted under this paragraph (a)(3)(iv) if the employee provides a written statement that coverage was being declined because the employee or dependent had other coverage; a plan cannot require anything more for the employee to satisfy the plan's requirement to provide a written statement. (For example, the plan cannot require that the statement be notarized.)

(v) The rules of this paragraph (a)(3) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual *D* enrolls in a group health plan maintained by Employer *Y*. At the time *D* enrolls, *Y* pays 70 percent of the cost of employee coverage and *D* pays the rest. *Y* announces that beginning January 1, *Y* will no longer make employer contributions towards the coverage. Employees may maintain coverage, however, if they pay the total cost of the coverage.

(ii) *Conclusion.* In this *Example 1,* employer contributions towards *D*'s coverage ceased on January 1 and the conditions of paragraph (a)(3)(ii) of this section are satisfied on this date (regardless of whether *D* elects to pay the total cost and continue coverage under *Y*'s plan).

Example 2. (i) *Facts.* A group health plan provides coverage through two options—Option 1 and Option 2. Employees can enroll in either option only within 30 days of hire or on January 1 of each year. Employee *A* is eligible for both options and enrolls in Option 1. Effective July 1 the plan terminates coverage under Option 1 and the plan does not create an immediate open enrollment opportunity into Option 2.

(ii) *Conclusion.* In this *Example 2, A* has experienced a loss of eligibility for coverage that satisfies paragraph (a)(3)(i) of this section, and has satisfied the other conditions for special enrollment under paragraph (a)(2)(i) of this section. Therefore, if *A* satisfies the other conditions of this paragraph (a), the plan must permit *A* to enroll in Option 2 as a special enrollee. (*A* may also be

eligible to enroll in another group health plan, such as a plan maintained by the employer of *A*'s spouse, as a special enrollee.) The outcome would be the same if Option 1 was terminated by an issuer and the plan made no other coverage available to *A*.

Example 3. (i) *Facts*. Individual *C* is covered under a group health plan maintained by Employer *X*. While covered under *X*'s plan, *C* was eligible for but did not enroll in a plan maintained by Employer *Z*, the employer of *C*'s spouse. *C* terminates employment with *X* and loses eligibility for coverage under *X*'s plan. *C* has a special enrollment right to enroll in *Z*'s plan, but *C* instead elects COBRA continuation coverage under *X*'s plan. *C* exhausts COBRA continuation coverage under *X*'s plan and requests special enrollment in *Z*'s plan.

(ii) *Conclusion*. In this *Example 3*, *C* has satisfied the conditions for special enrollment under paragraph (a)(3)(iii) of this section, and has satisfied the other conditions for special enrollment under paragraph (a)(2)(i) of this section. The special enrollment right that *C* had into *Z*'s plan immediately after the loss of eligibility for coverage under *X*'s plan was an offer of coverage under *Z*'s plan. When *C* later exhausts COBRA coverage under *X*'s plan, *C* has a second special enrollment right in *Z*'s plan.

(4) *Applying for special enrollment and effective date of coverage*—(i) A plan or issuer must allow an employee a period of at least 30 days after an event described in paragraph (a)(3) of this section (other than an event described in paragraph (a)(3)(i)(D)) to request enrollment (for the employee or the employee's dependent). In the case of an event described in paragraph (a)(3)(i)(D) of this section (relating to loss of eligibility for coverage due to the operation of a lifetime limit on all benefits), a plan or issuer must allow an employee a period of at least 30 days after a claim is denied due to the operation of a lifetime limit on all benefits.

(ii) Coverage must begin no later than the first day of the first calendar month beginning after the date the plan or issuer receives the request for special enrollment.

(b) *Special enrollment with respect to certain dependent beneficiaries*—(1) *In general*. A group health plan that makes coverage available with respect to dependents is required to permit individuals described in paragraph (b)(2) of this section to be enrolled for coverage in a benefit package under the terms of the plan. Paragraph (b)(3) of this section describes the required special enrollment period and the date by which coverage must begin. The special enrollment rights under this paragraph (b) apply without regard to the dates on which an individual would otherwise be able to enroll under the plan. (*See* 29 CFR 2590.701–6(b) and 45 CFR 146.117(b), under which this obligation is also imposed on a health insurance issuer offering group health insurance coverage.)

(2) *Individuals eligible for special enrollment*. An individual is described in this paragraph (b)(2) if the individual is otherwise eligible for coverage in a benefit package under the plan and if the individual is described in paragraph (b)(2)(i), (ii), (iii), (iv), (v), or (vi) of this section.

(i) *Current employee only*. A current employee is described in this paragraph (b)(2)(i) if a person becomes a dependent of the individual through marriage, birth, adoption, or placement for adoption.

(ii) *Spouse of a participant only*. An individual is described in this paragraph (b)(2)(ii) if either—

(A) The individual becomes the spouse of a participant; or

(B) The individual is a spouse of a participant and a child becomes a dependent of the participant through birth, adoption, or placement for adoption.

(iii) *Current employee and spouse*. A current employee and an individual who is or becomes a spouse of such an employee, are described in this paragraph (b)(2)(iii) if either—

(A) The employee and the spouse become married; or

(B) The employee and spouse are married and a child becomes a dependent of the employee through birth, adoption, or placement for adoption.

(iv) *Dependent of a participant only*. An individual is described in this paragraph (b)(2)(iv) if the individual is a dependent (as defined in §54.9801–2) of a participant and the individual has become a dependent of the participant through marriage, birth, adoption, or placement for adoption.

(v) *Current employee and a new dependent*. A current employee and an individual who is a dependent of the employee, are described in this paragraph

(b)(2)(v) if the individual becomes a dependent of the employee through marriage, birth, adoption, or placement for adoption.

(vi) *Current employee, spouse, and a new dependent.* A current employee, the employee's spouse, and the employee's dependent are described in this paragraph (b)(2)(vi) if the dependent becomes a dependent of the employee through marriage, birth, adoption, or placement for adoption.

(3) *Applying for special enrollment and effective date of coverage*—(i) *Request.* A plan must allow an individual a period of at least 30 days after the date of the marriage, birth, adoption, or placement for adoption (or, if dependent coverage is not generally made available at the time of the marriage, birth, adoption, or placement for adoption, a period of at least 30 days after the date the plan makes dependent coverage generally available) to request enrollment (for the individual or the individual's dependent).

(ii) *Reasonable procedures for special enrollment.* [Reserved]

(iii) *Date coverage must begin*—(A) *Marriage.* In the case of marriage, coverage must begin no later than the first day of the first calendar month beginning after the date the plan (or any issuer offering health insurance coverage under the plan) receives the request for special enrollment.

(B) *Birth, adoption, or placement for adoption.* Coverage must begin in the case of a dependent's birth on the date of birth and in the case of a dependent's adoption or placement for adoption no later than the date of such adoption or placement for adoption (or, if dependent coverage is not made generally available at the time of the birth, adoption, or placement for adoption, the date the plan makes dependent coverage available).

(4) *Examples.* The rules of this paragraph (b) are illustrated by the following examples:

Example 1. (i) *Facts.* An employer maintains a group health plan that offers all employees employee-only coverage, employee-plus-spouse coverage, or family coverage. Under the terms of the plan, any employee may elect to enroll when first hired (with coverage beginning on the date of hire) or during an annual open enrollment period held each December (with coverage beginning the following January 1). Employee *A* is hired on September 3. *A* is married to *B*, and they have no children. On March 15 in the following year a child *C* is born to *A* and *B*. Before that date, *A* and *B* have not been enrolled in the plan.

(ii) *Conclusion.* In this *Example 1*, the conditions for special enrollment of an employee with a spouse and new dependent under paragraph (b)(2)(vi) of this section are satisfied. If *A* satisfies the conditions of paragraph (b)(3) of this section for requesting enrollment timely, the plan will satisfy this paragraph (b) if it allows *A* to enroll either with employee-only coverage, with employee-plus-spouse coverage (for *A* and *B*), or with family coverage (for *A*, *B*, and *C*). The plan must allow whatever coverage is chosen to begin on March 15, the date of *C*'s birth.

Example 2. (i) *Facts.* Individual *D* works for Employer *X*. *X* maintains a group health plan with two benefit packages—an HMO option and an indemnity option. Self-only and family coverage are available under both options. *D* enrolls for self-only coverage in the HMO option. Then, a child, *E*, is placed for adoption with *D*. Within 30 days of the placement of *E* for adoption, *D* requests enrollment for *D* and *E* under the plan's indemnity option.

(ii) *Conclusion.* In this *Example 2*, *D* and *E* satisfy the conditions for special enrollment under paragraphs (b)(2)(v) and (b)(3) of this section. Therefore, the plan must allow *D* and *E* to enroll in the indemnity coverage, effective as of the date of the placement for adoption.

(c) *Notice of special enrollment.* At or before the time an employee is initially offered the opportunity to enroll in a group health plan, the plan must furnish the employee with a notice of special enrollment that complies with the requirements of this paragraph (c).

(1) *Description of special enrollment rights.* The notice of special enrollment must include a description of special enrollment rights. The following model language may be used to satisfy this requirement:

If you are declining enrollment for yourself or your dependents (including your spouse) because of other health insurance or group health plan coverage, you may be able to enroll yourself and your dependents in this plan if you or your dependents lose eligibility for that other coverage (or if the employer stops contributing towards your or your dependents' other coverage). However, you must request enrollment within [insert ''30 days'' or any longer period that applies

under the plan] after your or your dependents' other coverage ends (or after the employer stops contributing toward the other coverage).

In addition, if you have a new dependent as a result of marriage, birth, adoption, or placement for adoption, you may be able to enroll yourself and your dependents. However, you must request enrollment within [insert ''30 days'' or any longer period that applies under the plan] after the marriage, birth, adoption, or placement for adoption.

To request special enrollment or obtain more information, contact [insert the name, title, telephone number, and any additional contact information of the appropriate plan representative].

(2) *Additional information that may be required*. The notice of special enrollment must also include, if applicable, the notice described in paragraph (a)(3)(iv) of this section (the notice required to be furnished to an individual declining coverage if the plan requires the reason for declining coverage to be in writing).

(d) *Treatment of special enrollees*—(1) If an individual requests enrollment while the individual is entitled to special enrollment under either paragraph (a) or (b) of this section, the individual is a special enrollee, even if the request for enrollment coincides with a late enrollment opportunity under the plan. Therefore, the individual cannot be treated as a late enrollee.

(2) Special enrollees must be offered all the benefit packages available to similarly situated individuals who enroll when first eligible. For this purpose, any difference in benefits or cost-sharing requirements for different individuals constitutes a different benefit package. In addition, a special enrollee cannot be required to pay more for coverage than a similarly situated individual who enrolls in the same coverage when first eligible. The length of any preexisting condition exclusion that may be applied to a special enrollee cannot exceed the length of any preexisting condition exclusion that is applied to similarly situated individuals who enroll when first eligible. For rules prohibiting the application of a preexisting condition exclusion to certain newborns, adopted children, and children placed for adoption, see § 54.9801–3(b).

(3) The rules of this section are illustrated by the following example:

Example 2. (i) *Facts*. Employer *Y* maintains a group health plan that has an enrollment period for late enrollees every November 1 through November 30 with coverage effective the following January 1. On October 18, Individual *B* loses coverage under another group health plan and satisfies the requirements of paragraphs (a)(2), (3), and (4) of this section. *B* submits a completed application for coverage on November 2.

(ii) *Conclusion*. In this *Example*, *B* is a special enrollee. Therefore, even though *B*'s request for enrollment coincides with an open enrollment period, *B*'s coverage is required to be made effective no later than December 1 (rather than the plan's January 1 effective date for late enrollees).

[T.D. 9166, 69 FR 78746, Dec. 30, 2004]

§ 54.9802–1 Prohibiting discrimination against participants and beneficiaries based on a health factor.

(a) *Health factors*. (1) The term *health factor* means, in relation to an individual, any of the following health status-related factors:

(i) Health status;

(ii) Medical condition (including both physical and mental illnesses), as defined in § 54.9801–2;

(iii) Claims experience;

(iv) Receipt of health care;

(v) Medical history;

(vi) Genetic information, as defined in § 54.9802–3T.

(vii) Evidence of insurability; or

(viii) Disability.

(2) Evidence of insurability includes—

(i) Conditions arising out of acts of domestic violence; and

(ii) Participation in activities such as motorcycling, snowmobiling, all-terrain vehicle riding, horseback riding, skiing, and other similar activities.

(3) The decision whether health coverage is elected for an individual (including the time chosen to enroll, such as under special enrollment or late enrollment) is not, itself, within the scope of any health factor. (However, under § 54.9801–6, a plan must treat special enrollees the same as similarly situated individuals who are enrolled when first eligible.)

(b) *Prohibited discrimination in rules for eligibility*—(1) *In general*. (i) A group health plan may not establish any rule for eligibility (including continued eligibility) of any individual to enroll for benefits under the terms of the plan

that discriminates based on any health factor that relates to that individual or a dependent of that individual. This rule is subject to the provisions of paragraph (b)(2) of this section (explaining how this rule applies to benefits), paragraph (b)(3) of this section (allowing plans to impose certain preexisting condition exclusions), paragraph (d) of this section (containing rules for establishing groups of similarly situated individuals), paragraph (e) of this section (relating to nonconfinement, actively-at-work, and other service requirements), paragraph (f) of this section (relating to wellness programs), and paragraph (g) of this section (permitting favorable treatment of individuals with adverse health factors).

(ii) For purposes of this section, rules for eligibility include, but are not limited to, rules relating to—

(A) Enrollment;

(B) The effective date of coverage;

(C) Waiting (or affiliation) periods;

(D) Late and special enrollment;

(E) Eligibility for benefit packages (including rules for individuals to change their selection among benefit packages);

(F) Benefits (including rules relating to covered benefits, benefit restrictions, and cost-sharing mechanisms such as coinsurance, copayments, and deductibles), as described in paragraphs (b)(2) and (3) of this section;

(G) Continued eligibility; and

(H) Terminating coverage (including disenrollment) of any individual under the plan.

(iii) The rules of this paragraph (b)(1) are illustrated by the following examples:

Example 1. (i) *Facts.* An employer sponsors a group health plan that is available to all employees who enroll within the first 30 days of their employment. However, employees who do not enroll within the first 30 days cannot enroll later unless they pass a physical examination.

(ii) *Conclusion.* In this *Example 1,* the requirement to pass a physical examination in order to enroll in the plan is a rule for eligibility that discriminates based on one or more health factors and thus violates this paragraph (b)(1).

Example 2. (i) *Facts.* Under an employer's group health plan, employees who enroll during the first 30 days of employment (and during special enrollment periods) may choose between two benefit packages: An indemnity option and an HMO option. However, employees who enroll during late enrollment are permitted to enroll only in the HMO option and only if they provide evidence of good health.

(ii) *Conclusion.* In this *Example 2,* the requirement to provide evidence of good health in order to be eligible for late enrollment in the HMO option is a rule for eligibility that discriminates based on one or more health factors and thus violates this paragraph (b)(1). However, if the plan did not require evidence of good health but limited late enrollees to the HMO option, the plan's rules for eligibility would not discriminate based on any health factor, and thus would not violate this paragraph (b)(1), because the time an individual chooses to enroll is not, itself, within the scope of any health factor.

Example 3. (i) *Facts.* Under an employer's group health plan, all employees generally may enroll within the first 30 days of employment. However, individuals who participate in certain recreational activities, including motorcycling, are excluded from coverage.

(ii) *Conclusion.* In this *Example 3,* excluding from the plan individuals who participate in recreational activities, such as motorcycling, is a rule for eligibility that discriminates based on one or more health factors and thus violates this paragraph (b)(1).

Example 4. (i) *Facts.* A group health plan applies for a group health policy offered by an issuer. As part of the application, the issuer receives health information about individuals to be covered under the plan. Individual *A* is an employee of the employer maintaining the plan. *A* and *A*'s dependents have a history of high health claims. Based on the information about *A* and *A*'s dependents, the issuer excludes *A* and *A*'s dependents from the group policy it offers to the employer.

(ii) *Conclusion.* See *Example 4* in 29 CFR 2590.702(b)(1) and 45 CFR 146.121(b)(1) for a conclusion that the exclusion by the issuer of *A* and *A*'s dependents from coverage is a rule for eligibility that discriminates based on one or more health factors and violates rules under 29 CFR 2590.702(b)(1) and 45 CFR 146.121(b)(1) similar to the rules under this paragraph (b)(1). (If the employer is a small employer under 45 CFR 144.103 (generally, an employer with 50 or fewer employees), the issuer also may violate 45 CFR 146.150, which requires issuers to offer all the policies they sell in the small group market on a guaranteed available basis to all small employers and to accept every eligible individual in every small employer group.) If the plan provides coverage through this policy and does not provide equivalent coverage for *A* and *A*'s dependents through other means, the plan violates this paragraph (b)(1).

(2) *Application to benefits*—(i) *General rule*—(A) Under this section, a group health plan is not required to provide coverage for any particular benefit to any group of similarly situated individuals.

(B) However, benefits provided under a plan must be uniformly available to all similarly situated individuals (as described in paragraph (d) of this section). Likewise, any restriction on a benefit or benefits must apply uniformly to all similarly situated individuals and must not be directed at individual participants or beneficiaries based on any health factor of the participants or beneficiaries (determined based on all the relevant facts and circumstances). Thus, for example, a plan may limit or exclude benefits in relation to a specific disease or condition, limit or exclude benefits for certain types of treatments or drugs, or limit or exclude benefits based on a determination of whether the benefits are experimental or not medically necessary, but only if the benefit limitation or exclusion applies uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries based on any health factor of the participants or beneficiaries. In addition, a plan may impose annual, lifetime, or other limits on benefits and may require the satisfaction of a deductible, copayment, coinsurance, or other cost-sharing requirement in order to obtain a benefit if the limit or cost-sharing requirement applies uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries based on any health factor of the participants or beneficiaries. In the case of a cost-sharing requirement, see also paragraph (b)(2)(ii) of this section, which permits variances in the application of a cost-sharing mechanism made available under a wellness program. (Whether any plan provision or practice with respect to benefits complies with this paragraph (b)(2)(i) does not affect whether the provision or practice is permitted under ERISA, the Americans with Disabilities Act, or any other law, whether State or Federal.)

(C) For purposes of this paragraph (b)(2)(i), a plan amendment applicable to all individuals in one or more groups of similarly situated individuals under the plan and made effective no earlier than the first day of the first plan year after the amendment is adopted is not considered to be directed at any individual participants or beneficiaries.

(D) The rules of this paragraph (b)(2)(i) are illustrated by the following examples:

Example 1. (i) *Facts.* A group health plan applies a $500,000 lifetime limit on all benefits to each participant or beneficiary covered under the plan. The limit is not directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 1,* the limit does not violate this paragraph (b)(2)(i) because $500,000 of benefits are available uniformly to each participant and beneficiary under the plan and because the limit is applied uniformly to all participants and beneficiaries and is not directed at individual participants or beneficiaries.

Example 2. (i) *Facts.* A group health plan has a $2 million lifetime limit on all benefits (and no other lifetime limits) for participants covered under the plan. Participant *B* files a claim for the treatment of AIDS. At the next corporate board meeting of the plan sponsor, the claim is discussed. Shortly thereafter, the plan is modified to impose a $10,000 lifetime limit on benefits for the treatment of AIDS, effective before the beginning of the next plan year.

(ii) *Conclusion.* The facts of this *Example 2* strongly suggest that the plan modification is directed at *B* based on *B*'s claim. Absent outweighing evidence to the contrary, the plan violates this paragraph (b)(2)(i).

Example 3. (i) A group health plan applies for a group health policy offered by an issuer. Individual *C* is covered under the plan and has an adverse health condition. As part of the application, the issuer receives health information about the individuals to be covered, including information about *C*'s adverse health condition. The policy form offered by the issuer generally provides benefits for the adverse health condition that *C* has, but in this case the issuer offers the plan a policy modified by a rider that excludes benefits for *C* for that condition. The exclusionary rider is made effective the first day of the next plan year.

(ii) *Conclusion.* See *Example 3* in 29 CFR 2590.702(b)(2)(i) and 45 CFR 146.121(b)(2)(i) for a conclusion that the issuer violates rules under 29 CFR 2590.702(b)(2)(i) and 45 CFR 146.121(b)(2)(i) similar to the rules under this paragraph (b)(2)(i) because benefits for *C*'s condition are available to other individuals in the group of similarly situated individuals that includes *C* but are not available to *C*. Thus, the benefits are not uniformly available to all similarly situated individuals.

Even though the exclusionary rider is made effective the first day of the next plan year, because the rider does not apply to all similarly situated individuals, the issuer violates the rules under 29 CFR 2590.702(b)(2)(i) and 45 CFR 146.121(b)(2)(i). If the plan provides coverage through this policy and does not provide equivalent coverage for *C* through other means, the plan violates this paragraph (b)(2)(i).

Example 4. (i) *Facts.* A group health plan has a $2,000 lifetime limit for the treatment of temporomandibular joint syndrome (TMJ). The limit is applied uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 4*, the limit does not violate this paragraph (b)(2)(i) because $2,000 of benefits for the treatment of TMJ are available uniformly to all similarly situated individuals and a plan may limit benefits covered in relation to a specific disease or condition if the limit applies uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries. (This example does not address whether the plan provision is permissible under the Americans with Disabilities Act or any other applicable law.)

Example 5. (i) *Facts.* A group health plan applies a $2 million lifetime limit on all benefits. However, the $2 million lifetime limit is reduced to $10,000 for any participant or beneficiary covered under the plan who has a congenital heart defect.

(ii) *Conclusion.* In this *Example 5*, the lower lifetime limit for participants and beneficiaries with a congenital heart defect violates this paragraph (b)(2)(i) because benefits under the plan are not uniformly available to all similarly situated individuals and the plan's lifetime limit on benefits does not apply uniformly to all similarly situated individuals.

Example 6. (i) *Facts.* A group health plan limits benefits for prescription drugs to those listed on a drug formulary. The limit is applied uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 6*, the exclusion from coverage of drugs not listed on the drug formulary does not violate this paragraph (b)(2)(i) because benefits for prescription drugs listed on the formulary are uniformly available to all similarly situated individuals and because the exclusion of drugs not listed on the formulary applies uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries.

Example 7. (i) *Facts.* Under a group health plan, doctor visits are generally subject to a $250 annual deductible and 20 percent coinsurance requirement. However, prenatal doctor visits are not subject to any deductible or coinsurance requirement. These rules are applied uniformly to all similarly situated individuals and are not directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 7*, imposing different deductible and coinsurance requirements for prenatal doctor visits and other visits does not violate this paragraph (b)(2)(i) because a plan may establish different deductibles or coinsurance requirements for different services if the deductible or coinsurance requirement is applied uniformly to all similarly situated individuals and is not directed at individual participants or beneficiaries.

Example 8. (i) *Facts.* An employer sponsors a group health plan that is available to all current employees. Under the plan, the medical care expenses of each employee (and the employee's dependents) are reimbursed up to an annual maximum amount. The maximum reimbursement amount with respect to an employee for a year is $1500 multiplied by the number of years the employee has participated in the plan, reduced by the total reimbursements for prior years.

(ii) *Conclusion.* In this *Example 8*, the variable annual limit does not violate this paragraph (b)(2)(i). Although the maximum reimbursement amount for a year varies among employees within the same group of similarly situated individuals based on prior claims experience, employees who have participated in the plan for the same length of time are eligible for the same total benefit over that length of time (and the restriction on the maximum reimbursement amount is not directed at any individual participants or beneficiaries based on any health factor).

(ii) *Exception for wellness programs.* A group health plan may vary benefits, including cost-sharing mechanisms (such as a deductible, copayment, or coinsurance), based on whether an individual has met the standards of a wellness program that satisfies the requirements of paragraph (f) of this section.

(iii) *Specific rule relating to source-of-injury exclusions*—(A) If a group health plan generally provides benefits for a type of injury, the plan may not deny benefits otherwise provided for treatment of the injury if the injury results from an act of domestic violence or a medical condition (including both physical and mental health conditions). This rule applies in the case of an injury resulting from a medical condition even if the condition is not diagnosed before the injury.

(B) The rules of this paragraph (b)(2)(iii) are illustrated by the following examples:

Example 1. (i) *Facts.* A group health plan generally provides medical/surgical benefits, including benefits for hospital stays, that are medically necessary. However, the plan excludes benefits for self-inflicted injuries or injuries sustained in connection with attempted suicide. Because of depression, Individual *D* attempts suicide. As a result, *D* sustains injuries and is hospitalized for treatment of the injuries. Under the exclusion, the plan denies *D* benefits for treatment of the injuries.

(ii) *Conclusion.* In this *Example 1,* the suicide attempt is the result of a medical condition (depression). Accordingly, the denial of benefits for the treatments of *D*'s injuries violates the requirements of this paragraph (b)(2)(iii) because the plan provision excludes benefits for treatment of an injury resulting from a medical condition.

Example 2. (i) *Facts.* A group health plan provides benefits for head injuries generally. The plan also has a general exclusion for any injury sustained while participating in any of a number of recreational activities, including bungee jumping. However, this exclusion does not apply to any injury that results from a medical condition (nor from domestic violence). Participant *E* sustains a head injury while bungee jumping. The injury did not result from a medical condition (nor from domestic violence). Accordingly, the plan denies benefits for *E*'s head injury.

(ii) *Conclusion.* In this *Example 2,* the plan provision that denies benefits based on the source of an injury does not restrict benefits based on an act of domestic violence or any medical condition. Therefore, the provision is permissible under this paragraph (b)(2)(iii) and does not violate this section. (However, if the plan did not allow *E* to enroll in the plan (or applied different rules for eligibility to *E*) because *E* frequently participates in bungee jumping, the plan would violate paragraph (b)(1) of this section.)

(3) *Relationship to § 54.9801–3.* (i) A preexisting condition exclusion is permitted under this section if it—

(A) Complies with § 54.9801–3;

(B) Applies uniformly to all similarly situated individuals (as described in paragraph (d) of this section); and

(C) Is not directed at individual participants or beneficiaries based on any health factor of the participants or beneficiaries. For purposes of this paragraph (b)(3)(i)(C), a plan amendment relating to a preexisting condition exclusion applicable to all individuals in one or more groups of similarly situated individuals under the plan and made effective no earlier than the first day of the first plan year after the amendment is adopted is not considered to be directed at any individual participants or beneficiaries.

(ii) The rules of this paragraph (b)(3) are illustrated by the following examples:

Example 1. (i) *Facts.* A group health plan imposes a preexisting condition exclusion on all individuals enrolled in the plan. The exclusion applies to conditions for which medical advice, diagnosis, care, or treatment was recommended or received within the six-month period ending on an individual's enrollment date. In addition, the exclusion generally extends for 12 months after an individual's enrollment date, but this 12-month period is offset by the number of days of an individual's creditable coverage in accordance with § 54.9801–3. There is nothing to indicate that the exclusion is directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 1,* even though the plan's preexisting condition exclusion discriminates against individuals based on one or more health factors, the preexisting condition exclusion does not violate this section because it applies uniformly to all similarly situated individuals, is not directed at individual participants or beneficiaries, and complies with § 54.9801–3 (that is, the requirements relating to the six-month look-back period, the 12-month (or 18-month) maximum exclusion period, and the creditable coverage offset).

Example 2. (i) *Facts.* A group health plan excludes coverage for conditions with respect to which medical advice, diagnosis, care, or treatment was recommended or received within the six-month period ending on an individual's enrollment date. Under the plan, the preexisting condition exclusion generally extends for 12 months, offset by creditable coverage. However, if an individual has no claims in the first six months following enrollment, the remainder of the exclusion period is waived.

(ii) *Conclusion.* In this *Example 2,* the plan's preexisting condition exclusions violate this section because they do not meet the requirements of this paragraph (b)(3); specifically, they do not apply uniformly to all similarly situated individuals. The plan provisions do not apply uniformly to all similarly situated individuals because individuals who have medical claims during the first six months following enrollment are not treated the same as similarly situated individuals with no claims during that period. (Under paragraph (d) of this section, the groups cannot be treated as two separate

groups of similarly situated individuals because the distinction is based on a health factor.)

(c) *Prohibited discrimination in premiums or contributions*—(1) *In general*—(i) A group health plan may not require an individual, as a condition of enrollment or continued enrollment under the plan, to pay a premium or contribution that is greater than the premium or contribution for a similarly situated individual (described in paragraph (d) of this section) enrolled in the plan based on any health factor that relates to the individual or a dependent of the individual.

(ii) Discounts, rebates, payments in kind, and any other premium differential mechanisms are taken into account in determining an individual's premium or contribution rate. (For rules relating to cost-sharing mechanisms, see paragraph (b)(2) of this section (addressing benefits).)

(2) *Rules relating to premium rates*—(i) *Group rating based on health factors not restricted under this section.* Nothing in this section restricts the aggregate amount that an employer may be charged for coverage under a group health plan. But *see* § 54.9802–3T(b), which prohibits adjustments in group premium or contribution rates based on genetic information.

(ii) *List billing based on a health factor prohibited.* However, a group health plan may not quote or charge an employer (or an individual) a different premium for an individual in a group of similarly situated individuals based on a health factor. (But see paragraph (g) of this section permitting favorable treatment of individuals with adverse health factors.)

(iii) *Examples.* The rules of this paragraph (c)(2) are illustrated by the following examples:

Example 1. (i) *Facts.* An employer sponsors a group health plan and purchases coverage from a health insurance issuer. In order to determine the premium rate for the upcoming plan year, the issuer reviews the claims experience of individuals covered under the plan. The issuer finds that Individual F had significantly higher claims experience than similarly situated individuals in the plan. The issuer quotes the plan a higher per-participant rate because of F's claims experience.

(ii) *Conclusion. See Example 1* in 29 CFR 2590.702(c)(2) and 45 CFR 146.121(c)(2) for a conclusion that the issuer does not violate the provisions of 29 CFR 2590.702(c)(2) and 45 CFR 146.121(c)(2) similar to the provisions of this paragraph (c)(2) because the issuer blends the rate so that the employer is not quoted a higher rate for F than for a similarly situated individual based on F's claims experience. (However, those examples conclude that if the issuer used genetic information in computing the group rate, it would violate 29 CFR 2590.702–1(b) or 45 CFR 146.122(b).)

Example 2. (i) *Facts.* Same facts as *Example 1,* except that the issuer quotes the employer a higher premium rate for *F,* because of *F*'s claims experience, than for a similarly situated individual.

(ii) *Conclusion.* See *Example 2* in 29 CFR 2590.702(c)(2) and 45 CFR 146.121(c)(2) for a conclusion that the issuer violates provisions of 29 CFR 2590.702(c)(2) and 45 CFR 146.121(c)(2) similar to the provisions of this paragraph (c)(2). Moreover, even if the plan purchased the policy based on the quote but did not require a higher participant contribution for *F* than for a similarly situated individual, see *Example 2* in 29 CFR 2590.702(c)(2) and 45 CFR 146.121(c)(2) for a conclusion that the issuer would still violate 29 CFR 2590.702(c)(2) and 45 CFR 146.121(c)(2) (but in such a case the plan would not violate this paragraph (c)(2)).

(3) *Exception for wellness programs.* Notwithstanding paragraphs (c)(1) and (2) of this section, a plan may vary the amount of premium or contribution it requires similarly situated individuals to pay based on whether an individual has met the standards of a wellness program that satisfies the requirements of paragraph (f) of this section.

(d) *Similarly situated individuals.* The requirements of this section apply only within a group of individuals who are treated as similarly situated individuals. A plan may treat participants as a group of similarly situated individuals separate from beneficiaries. In addition, participants may be treated as two or more distinct groups of similarly situated individuals and beneficiaries may be treated as two or more distinct groups of similarly situated individuals in accordance with the rules of this paragraph (d). Moreover, if individuals have a choice of two or more benefit packages, individuals choosing one benefit package may be treated as one or more groups of similarly situated individuals distinct from individuals choosing another benefit package.

(1) *Participants.* Subject to paragraph (d)(3) of this section, a plan may treat participants as two or more distinct groups of similarly situated individuals if the distinction between or among the groups of participants is based on a bona fide employment-based classification consistent with the employer's usual business practice. Whether an employment-based classification is bona fide is determined on the basis of all the relevant facts and circumstances. Relevant facts and circumstances include whether the employer uses the classification for purposes independent of qualification for health coverage (for example, determining eligibility for other employee benefits or determining other terms of employment). Subject to paragraph (d)(3) of this section, examples of classifications that, based on all the relevant facts and circumstances, may be bona fide include full-time versus part-time status, different geographic location, membership in a collective bargaining unit, date of hire, length of service, current employee versus former employee status, and different occupations. However, a classification based on any health factor is not a bona fide employment-based classification, unless the requirements of paragraph (g) of this section are satisfied (permitting favorable treatment of individuals with adverse health factors).

(2) *Beneficiaries*—(i) Subject to paragraph (d)(3) of this section, a plan may treat beneficiaries as two or more distinct groups of similarly situated individuals if the distinction between or among the groups of beneficiaries is based on any of the following factors:

(A) A bona fide employment-based classification of the participant through whom the beneficiary is receiving coverage;

(B) Relationship to the participant (for example, as a spouse or as a dependent child);

(C) Marital status;

(D) With respect to children of a participant, age or student status; or

(E) Any other factor if the factor is not a health factor.

(ii) Paragraph (d)(2)(i) of this section does not prevent more favorable treatment of individuals with adverse health factors in accordance with paragraph (g) of this section.

(3) *Discrimination directed at individuals.* Notwithstanding paragraphs (d)(1) and (2) of this section, if the creation or modification of an employment or coverage classification is directed at individual participants or beneficiaries based on any health factor of the participants or beneficiaries, the classification is not permitted under this paragraph (d), unless it is permitted under paragraph (g) of this section (permitting favorable treatment of individuals with adverse health factors). Thus, if an employer modified an employment-based classification to single out, based on a health factor, individual participants and beneficiaries and deny them health coverage, the new classification would not be permitted under this section.

(4) *Examples.* The rules of this paragraph (d) are illustrated by the following examples:

Example 1. (i) *Facts.* An employer sponsors a group health plan for full-time employees only. Under the plan (consistent with the employer's usual business practice), employees who normally work at least 30 hours per week are considered to be working full-time. Other employees are considered to be working part-time. There is no evidence to suggest that the classification is directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 1,* treating the full-time and part-time employees as two separate groups of similarly situated individuals is permitted under this paragraph (d) because the classification is bona fide and is not directed at individual participants or beneficiaries.

Example 2. (i) *Facts.* Under a group health plan, coverage is made available to employees, their spouses, and their dependent children. However, coverage is made available to a dependent child only if the dependent child is under age 19 (or under age 25 if the child is continuously enrolled full-time in an institution of higher learning (full-time students)). There is no evidence to suggest that these classifications are directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 2,* treating spouses and dependent children differently by imposing an age limitation on dependent children, but not on spouses, is permitted under this paragraph (d). Specifically, the distinction between spouses and dependent children is permitted under paragraph (d)(2) of this section and is not prohibited under paragraph (d)(3) of this section because it is not directed at individual participants or

beneficiaries. It is also permissible to treat dependent children who are under age 19 (or full-time students under age 25) as a group of similarly situated individuals separate from those who are age 25 or older (or age 19 or older if they are not full-time students) because the classification is permitted under paragraph (d)(2) of this section and is not directed at individual participants or beneficiaries.

Example 3. (i) *Facts.* A university sponsors a group health plan that provides one health benefit package to faculty and another health benefit package to other staff. Faculty and staff are treated differently with respect to other employee benefits such as retirement benefits and leaves of absence. There is no evidence to suggest that the distinction is directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 3,* the classification is permitted under this paragraph (d) because there is a distinction based on a bona fide employment-based classification consistent with the employer's usual business practice and the distinction is not directed at individual participants and beneficiaries.

Example 4. (i) *Facts.* An employer sponsors a group health plan that is available to all current employees. Former employees may also be eligible, but only if they complete a specified number of years of service, are enrolled under the plan at the time of termination of employment, and are continuously enrolled from that date. There is no evidence to suggest that these distinctions are directed at individual participants or beneficiaries.

(ii) *Conclusion.* In this *Example 4,* imposing additional eligibility requirements on former employees is permitted because a classification that distinguishes between current and former employees is a bona fide employment-based classification that is permitted under this paragraph (d), provided that it is not directed at individual participants or beneficiaries. In addition, it is permissible to distinguish between former employees who satisfy the service requirement and those who do not, provided that the distinction is not directed at individual participants or beneficiaries. (However, former employees who do not satisfy the eligibility criteria may, nonetheless, be eligible for continued coverage pursuant to a COBRA continuation provision or similar State law.)

Example 5. (i) *Facts.* An employer sponsors a group health plan that provides the same benefit package to all seven employees of the employer. Six of the seven employees have the same job title and responsibilities, but Employee *G* has a different job title and different responsibilities. After *G* files an expensive claim for benefits under the plan, coverage under the plan is modified so that employees with *G*'s job title receive a different benefit package that includes a lower lifetime dollar limit than in the benefit package made available to the other six employees.

(ii) *Conclusion.* Under the facts of this *Example 5,* changing the coverage classification for *G* based on the existing employment classification for *G* is not permitted under this paragraph (d) because the creation of the new coverage classification for *G* is directed at *G* based on one or more health factors.

(e) *Nonconfinement and actively-at-work provisions*—(1) *Nonconfinement provisions*—(i) *General rule.* Under the rules of paragraphs (b) and (c) of this section, a plan may not establish a rule for eligibility (as described in paragraph (b)(1)(ii) of this section) or set any individual's premium or contribution rate based on whether an individual is confined to a hospital or other health care institution. In addition, under the rules of paragraphs (b) and (c) of this section, a plan may not establish a rule for eligibility or set any individual's premium or contribution rate based on an individual's ability to engage in normal life activities, except to the extent permitted under paragraphs (e)(2)(ii) and (3) of this section (permitting plans, under certain circumstances, to distinguish among employees based on the performance of services).

(ii) *Examples.* The rules of this paragraph (e)(1) are illustrated by the following examples:

Example 1. (i) *Facts.* Under a group health plan, coverage for employees and their dependents generally becomes effective on the first day of employment. However, coverage for a dependent who is confined to a hospital or other health care institution does not become effective until the confinement ends.

(ii) *Conclusion.* In this *Example 1,* the plan violates this paragraph (e)(1) because the plan delays the effective date of coverage for dependents based on confinement to a hospital or other health care institution.

Example 2. (i) *Facts.* In previous years, a group health plan has provided coverage through a group health insurance policy offered by Issuer *M.* However, for the current year, the plan provides coverage through a group health insurance policy offered by Issuer *N.* Under Issuer *N*'s policy, items and services provided in connection with the confinement of a dependent to a hospital or other health care institution are not covered if the confinement is covered under an extension of benefits clause from a previous health insurance issuer.

(ii) *Conclusion*. See *Example 2* in 29 CFR 2590.702(e)(1) and 45 CFR 146.121(e)(1) for a conclusion that Issuer *N* violates provisions of 29 CFR 2590.702(e)(1) and 45 CFR 146.121(e)(1) similar to the provisions of this paragraph (e)(1) because the group health insurance coverage restricts benefits based on whether a dependent is confined to a hospital or other health care institution that is covered under an extension of benefits from a previous issuer. See *Example 2* in 29 CFR 2590.702(e)(1) and 45 CFR 146.121(e)(1) for the additional conclusions that under State law Issuer *M* may also be responsible for providing benefits to such a dependent; and that in a case in which Issuer *N* has an obligation under 29 CFR 2590.702(e)(1) or 45 CFR 146.121(e)(1) to provide benefits and Issuer *M* has an obligation under State law to provide benefits, any State laws designed to prevent more than 100% reimbursement, such as State coordination-of-benefits laws, continue to apply.

(2) *Actively-at-work and continuous service provisions*—(i) *General rule*—(A) Under the rules of paragraphs (b) and (c) of this section and subject to the exception for the first day of work described in paragraph (e)(2)(ii) of this section, a plan may not establish a rule for eligibility (as described in paragraph (b)(1)(ii) of this section) or set any individual's premium or contribution rate based on whether an individual is actively at work (including whether an individual is continuously employed), unless absence from work due to any health factor (such as being absent from work on sick leave) is treated, for purposes of the plan, as being actively at work.

(B) The rules of this paragraph (e)(2)(i) are illustrated by the following examples:

Example 1. (i) *Facts*. Under a group health plan, an employee generally becomes eligible to enroll 30 days after the first day of employment. However, if the employee is not actively at work on the first day after the end of the 30-day period, then eligibility for enrollment is delayed until the first day the employee is actively at work.

(ii) *Conclusion*. In this *Example 1*, the plan violates this paragraph (e)(2) (and thus also violates paragraph (b) of this section). However, the plan would not violate paragraph (e)(2) or (b) of this section if, under the plan, an absence due to any health factor is considered being actively at work.

Example 2. (i) *Facts*. Under a group health plan, coverage for an employee becomes effective after 90 days of continuous service; that is, if an employee is absent from work (for any reason) before completing 90 days of service, the beginning of the 90-day period is measured from the day the employee returns to work (without any credit for service before the absence).

(ii) *Conclusion*. In this *Example 2*, the plan violates this paragraph (e)(2) (and thus also paragraph (b) of this section) because the 90-day continuous service requirement is a rule for eligibility based on whether an individual is actively at work. However, the plan would not violate this paragraph (e)(2) or paragraph (b) of this section if, under the plan, an absence due to any health factor is not considered an absence for purposes of measuring 90 days of continuous service.

(ii) *Exception for the first day of work*—(A) Notwithstanding the general rule in paragraph (e)(2)(i) of this section, a plan may establish a rule for eligibility that requires an individual to begin work for the employer sponsoring the plan (or, in the case of a multiemployer plan, to begin a job in covered employment) before coverage becomes effective, provided that such a rule for eligibility applies regardless of the reason for the absence.

(B) The rules of this paragraph (e)(2)(ii) are illustrated by the following examples:

Example 1. (i) *Facts*. Under the eligibility provision of a group health plan, coverage for new employees becomes effective on the first day that the employee reports to work. Individual *H* is scheduled to begin work on August 3. However, *H* is unable to begin work on that day because of illness. *H* begins working on August 4, and *H*'s coverage is effective on August 4.

(ii) *Conclusion*. In this *Example 1*, the plan provision does not violate this section. However, if coverage for individuals who do not report to work on the first day they were scheduled to work for a reason unrelated to a health factor (such as vacation or bereavement) becomes effective on the first day they were scheduled to work, then the plan would violate this section.

Example 2. (i) *Facts*. Under a group health plan, coverage for new employees becomes effective on the first day of the month following the employee's first day of work, regardless of whether the employee is actively at work on the first day of the month. Individual *J* is scheduled to begin work on March 24. However, *J* is unable to begin work on March 24 because of illness. *J* begins working on April 7 and *J*'s coverage is effective May 1.

(ii) *Conclusion*. In this *Example 2*, the plan provision does not violate this section. However, as in *Example 1*, if coverage for individuals absent from work for reasons unrelated

to a health factor became effective despite their absence, then the plan would violate this section.

(3) *Relationship to plan provisions defining similarly situated individuals*—(i) Notwithstanding the rules of paragraphs (e)(1) and (2) of this section, a plan may establish rules for eligibility or set any individual's premium or contribution rate in accordance with the rules relating to similarly situated individuals in paragraph (d) of this section. Accordingly, a plan may distinguish in rules for eligibility under the plan between full-time and part-time employees, between permanent and temporary or seasonal employees, between current and former employees, and between employees currently performing services and employees no longer performing services for the employer, subject to paragraph (d) of this section. However, other Federal or State laws (including the COBRA continuation provisions and the Family and Medical Leave Act of 1993) may require an employee or the employee's dependents to be offered coverage and set limits on the premium or contribution rate even though the employee is not performing services.

(ii) The rules of this paragraph (e)(3) are illustrated by the following examples:

Example 1. (i) *Facts.* Under a group health plan, employees are eligible for coverage if they perform services for the employer for 30 or more hours per week or if they are on paid leave (such as vacation, sick, or bereavement leave). Employees on unpaid leave are treated as a separate group of similarly situated individuals in accordance with the rules of paragraph (d) of this section.

(ii) *Conclusion.* In this *Example 1,* the plan provisions do not violate this section. However, if the plan treated individuals performing services for the employer for 30 or more hours per week, individuals on vacation leave, and individuals on bereavement leave as a group of similarly situated individuals separate from individuals on sick leave, the plan would violate this paragraph (e) (and thus also would violate paragraph (b) of this section) because groups of similarly situated individuals cannot be established based on a health factor (including the taking of sick leave) under paragraph (d) of this section.

Example 2. (i) *Facts.* To be eligible for coverage under a bona fide collectively bargained group health plan in the current calendar quarter, the plan requires an individual to have worked 250 hours in covered employment during the three-month period that ends one month before the beginning of the current calendar quarter. The distinction between employees working at least 250 hours and those working less than 250 hours in the earlier three-month period is not directed at individual participants or beneficiaries based on any health factor of the participants or beneficiaries.

(ii) *Conclusion.* In this *Example 2,* the plan provision does not violate this section because, under the rules for similarly situated individuals allowing full-time employees to be treated differently than part-time employees, employees who work at least 250 hours in a three-month period can be treated differently than employees who fail to work 250 hours in that period. The result would be the same if the plan permitted individuals to apply excess hours from previous periods to satisfy the requirement for the current quarter.

Example 3. (i) *Facts.* Under a group health plan, coverage of an employee is terminated when the individual's employment is terminated, in accordance with the rules of paragraph (d) of this section. Employee *B* has been covered under the plan. *B* experiences a disabling illness that prevents *B* from working. *B* takes a leave of absence under the Family and Medical Leave Act of 1993. At the end of such leave, *B* terminates employment and consequently loses coverage under the plan. (This termination of coverage is without regard to whatever rights the employee (or members of the employee's family) may have for COBRA continuation.)

(ii) *Conclusion.* In this *Example 3,* the plan provision terminating *B*'s coverage upon *B*'s termination of employment does not violate this section.

Example 4. (i) *Facts.* Under a group health plan, coverage of an employee is terminated when the employee ceases to perform services for the employer sponsoring the plan, in accordance with the rules of paragraph (d) of this section. Employee *C* is laid off for three months. When the layoff begins, *C*'s coverage under the plan is terminated. (This termination of coverage is without regard to whatever rights the employee (or members of the employee's family) may have for COBRA continuation coverage.)

(ii) *Conclusion.* In this *Example 4,* the plan provision terminating *C*'s coverage upon the cessation of *C*'s performance of services does not violate this section.

(f) *Wellness programs.* A wellness program is any program designed to promote health or prevent disease. Paragraphs (b)(2)(ii) and (c)(3) of this section provide exceptions to the general prohibitions against discrimination

based on a health factor for plan provisions that vary benefits (including cost-sharing mechanisms) or the premium or contribution for similarly situated individuals in connection with a wellness program that satisfies the requirements of this paragraph (f). If none of the conditions for obtaining a reward under a wellness program is based on an individual satisfying a standard that is related to a health factor, paragraph (f)(1) of this section clarifies that the wellness program does not violate this section if participation in the program is made available to all similarly situated individuals. If any of the conditions for obtaining a reward under a wellness program is based on an individual satisfying a standard that is related to a health factor, the wellness program does not violate this section if the requirements of paragraph (f)(2) of this section are met.

(1) *Wellness programs not subject to requirements.* If none of the conditions for obtaining a reward under a wellness program are based on an individual satisfying a standard that is related to a health factor (or if a wellness program does not provide a reward), the wellness program does not violate this section, if participation in the program is made available to all similarly situated individuals. Thus, for example, the following programs need not satisfy the requirements of paragraph (f)(2) of this section, if participation in the program is made available to all similarly situated individuals:

(i) A program that reimburses all or part of the cost for memberships in a fitness center.

(ii) A diagnostic testing program that provides a reward for participation and does not base any part of the reward on outcomes.

(iii) A program that encourages preventive care through the waiver of the copayment or deductible requirement under a group health plan for the costs of, for example, prenatal care or well-baby visits.

(iv) A program that reimburses employees for the costs of smoking cessation programs without regard to whether the employee quits smoking.

(v) A program that provides a reward to employees for attending a monthly health education seminar.

(2) *Wellness programs subject to requirements.* If any of the conditions for obtaining a reward under a wellness program is based on an individual satisfying a standard that is related to a health factor, the wellness program does not violate this section if the requirements of this paragraph (f)(2) are met.

(i) The reward for the wellness program, coupled with the reward for other wellness programs with respect to the plan that require satisfaction of a standard related to a health factor, must not exceed 20 percent of the cost of employee-only coverage under the plan. However, if, in addition to employees, any class of dependents (such as spouses or spouses and dependent children) may participate in the wellness program, the reward must not exceed 20 percent of the cost of the coverage in which an employee and any dependents are enrolled. For purposes of this paragraph (f)(2), the cost of coverage is determined based on the total amount of employer and employee contributions for the benefit package under which the employee is (or the employee and any dependents are) receiving coverage. A reward can be in the form of a discount or rebate of a premium or contribution, a waiver of all or part of a cost-sharing mechanism (such as deductibles, copayments, or coinsurance), the absence of a surcharge, or the value of a benefit that would otherwise not be provided under the plan.

(ii) The program must be reasonably designed to promote health or prevent disease. A program satisfies this standard if it has a reasonable chance of improving the health of or preventing disease in participating individuals and it is not overly burdensome, is not a subterfuge for discriminating based on a health factor, and is not highly suspect in the method chosen to promote health or prevent disease.

(iii) The program must give individuals eligible for the program the opportunity to qualify for the reward under the program at least once per year.

(iv) The reward under the program must be available to all similarly situated individuals.

(A) A reward is not available to all similarly situated individuals for a period unless the program allows—

(*1*) A reasonable alternative standard (or waiver of the otherwise applicable standard) for obtaining the reward for any individual for whom, for that period, it is unreasonably difficult due to a medical condition to satisfy the otherwise applicable standard; and

(*2*) A reasonable alternative standard (or waiver of the otherwise applicable standard) for obtaining the reward for any individual for whom, for that period, it is medically inadvisable to attempt to satisfy the otherwise applicable standard.

(B) A plan or issuer may seek verification, such as a statement from an individual's physician, that a health factor makes it unreasonably difficult or medically inadvisable for the individual to satisfy or attempt to satisfy the otherwise applicable standard.

(v)(A) The plan must disclose in all plan materials describing the terms of the program the availability of a reasonable alternative standard (or the possibility of waiver of the otherwise applicable standard) required under paragraph (f)(2)(iv) of this section. However, if plan materials merely mention that a program is available, without describing its terms, this disclosure is not required.

(B) The following language, or substantially similar language, can be used to satisfy the requirement of this paragraph (f)(2)(v): ''If it is unreasonably difficult due to a medical condition for you to achieve the standards for the reward under this program, or if it is medically inadvisable for you to attempt to achieve the standards for the reward under this program, call us at [insert telephone number] and we will work with you to develop another way to qualify for the reward.'' In addition, other examples of language that would satisfy this requirement are set forth in *Examples 3*, *4*, and *5* of paragraph (f)(3) of this section.

(3) *Examples*. The rules of paragraph (f)(2) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. An employer sponsors a group health plan. The annual premium for employee-only coverage is $3,600 (of which the employer pays $2,700 per year and the employee pays $900 per year). The annual premium for family coverage is $9,000 (of which the employer pays $4,500 per year and the employee pays $4,500 per year). The plan offers a wellness program with an annual premium rebate of $360. The program is available only to employees.

(ii) *Conclusion*. In this *Example 1*, the program satisfies the requirements of paragraph (f)(2)(i) of this section because the reward for the wellness program, $360, does not exceed 20 percent of the total annual cost of employee-only coverage, $720. ($3,600 × 20% = $720.) If any class of dependents is allowed to participate in the program and the employee is enrolled in family coverage, the plan could offer the employee a reward of up to 20 percent of the cost of family coverage, $1,800. ($9,000 × 20% = $1,800.)

Example 2. (i) *Facts*. A group health plan gives an annual premium discount of 20 percent of the cost of employee-only coverage to participants who adhere to a wellness program. The wellness program consists solely of giving an annual cholesterol test to participants. Those participants who achieve a count under 200 receive the premium discount for the year.

(ii) *Conclusion*. In this *Example 2*, the program fails to satisfy the requirement of being available to all similarly situated individuals because some participants may be unable to achieve a cholesterol count of under 200 and the plan does not make available a reasonable alternative standard or waive the cholesterol standard. (In addition, plan materials describing the program are required to disclose the availability of a reasonable alternative standard (or the possibility of waiver of the otherwise applicable standard) for obtaining the premium discount. Thus, the premium discount violates paragraph (c) of this section because it may require an individual to pay a higher premium based on a health factor of the individual than is required of a similarly situated individual under the plan.

Example 3. (i) *Facts*. Same facts as *Example 2*, except that the plan provides that if it is unreasonably difficult due to a medical condition for a participant to achieve the targeted cholesterol count (or if it is medically inadvisable for a participant to attempt to achieve the targeted cholesterol count) within a 60-day period, the plan will make available a reasonable alternative standard that takes the relevant medical condition into account. In addition, all plan materials describing the terms of the program include the following statement: ''If it is unreasonably difficult due to a medical condition for you to achieve a cholesterol count under 200,

or if it is medically inadvisable for you to attempt to achieve a count under 200, call us at the number below and we will work with you to develop another way to get the discount.'' Individual *D* begins a diet and exercise program but is unable to achieve a cholesterol count under 200 within the prescribed period. *D*'s doctor determines *D* requires prescription medication to achieve a medically advisable cholesterol count. In addition, the doctor determines that *D* must be monitored through periodic blood tests to continually reevaluate *D*'s health status. The plan accommodates *D* by making the discount available to *D*, but only if *D* follows the advice of *D*'s doctor's regarding medication and blood tests.

(ii) *Conclusion*. In this *Example 3*, the program is a wellness program because it satisfies the five requirements of paragraph (f)(2) of this section. First, the program complies with the limits on rewards under a program. Second, it is reasonably designed to promote health or prevent disease. Third, individuals eligible for the program are given the opportunity to qualify for the reward at least once per year. Fourth, the reward under the program is available to all similarly situated individuals because it accommodates individuals for whom it is unreasonably difficult due to a medical condition to achieve the targeted count (or for whom it is medically inadvisable to attempt to achieve the targeted count) in the prescribed period by providing a reasonable alternative standard. Fifth, the plan discloses in all materials describing the terms of the program the availability of a reasonable alternative standard. Thus, the premium discount does not violate this section.

Example 4. (i) *Facts*. A group health plan will waive the $250 annual deductible (which is less than 20 percent of the annual cost of employee-only coverage under the plan) for the following year for participants who have a body mass index between 19 and 26, determined shortly before the beginning of the year. However, any participant for whom it is unreasonably difficult due to a medical condition to attain this standard (and any participant for whom it is medically inadvisable to attempt to achieve this standard) during the plan year is given the same discount if the participant walks for 20 minutes three days a week. Any participant for whom it is unreasonably difficult due to a medical condition to attain either standard (and any participant for whom it is medically inadvisable to attempt to achieve either standard) during the year is given the same discount if the individual satisfies an alternative standard that is reasonable in the burden it imposes and is reasonable taking into consideration the individual's medical situation. All plan materials describing the terms of the wellness program include the following statement: ''If it is unreasonably difficult due to a medical condition for you to achieve a body mass index between 19 and 26 (or if it is medically inadvisable for you to attempt to achieve this body mass index) this year, your deductible will be waived if you walk for 20 minutes three days a week. If you cannot follow the walking program, call us at the number above and we will work with you to develop another way to have your deductible waived.'' Due to a medical condition, Individual *E* is unable to achieve a BMI of between 19 and 26 and is also unable to follow the walking program. *E* proposes a program based on the *recommendations of E's* physician. The plan agrees to make the discount available to *E* if *E* follows the physician's recommendations.

(ii) *Conclusion*. In this *Example 4*, the program satisfies the five requirements of paragraph (f)(2) of this section. First, the program complies with the limits on rewards under a program. Second, it is reasonably designed to promote health or prevent disease. Third, individuals eligible for the program are given the opportunity to qualify for the reward at least once per year. Fourth, the reward under the program is available to all similarly situated individuals because it generally accommodates individuals for whom it is unreasonably difficult due to a medical condition to achieve (or for whom it is medically inadvisable to attempt to achieve) the targeted body mass index by providing a reasonable alternative standard (walking) and it accommodates individuals for whom it is unreasonably difficult due to a medical condition (or for whom it is medically inadvisable to attempt) to walk by providing an alternative standard that is reasonable for the individual. Fifth, the plan discloses in all materials describing the terms of the program the availability of a reasonable alternative standard for every individual. Thus, the waiver of the deductible does not violate this section.

Example 5. (i) *Facts*. In conjunction with an annual open enrollment period, a group health plan provides a form for participants to certify that they have not used tobacco products in the preceding twelve months. Participants who do not provide the certification are assessed a surcharge that is 20 percent of the cost of employee-only coverage. However, all plan materials describing the terms of the wellness program include the following statement: ''If it is unreasonably difficult due to a health factor for you to meet the requirements under this program (or if it is medically inadvisable for you to attempt to meet the requirements of this program), we will make available a reasonable alternative standard for you to avoid this surcharge.'' It is unreasonably difficult for Individual *F* to stop smoking cigarettes due to an addiction to nicotine (a medical

condition). The plan accommodates *F* by requiring *F* to participate in a smoking cessation program to avoid the surcharge. *F* can avoid the surcharge for as long as *F* participates in the program, regardless of whether *F* stops smoking (as long as *F* continues to be addicted to nicotine).

(ii) *Conclusion*. In this *Example 5*, the premium surcharge is permissible as a wellness program because it satisfies the five requirements of paragraph (f)(2) of this section. First, the program complies with the limits on rewards under a program. Second, it is reasonably designed to promote health or prevent disease. Third, individuals eligible for the program are given the opportunity to qualify for the reward at least once per year. Fourth, the reward under the program is available to all similarly situated individuals because it accommodates individuals for whom it is unreasonably difficult due to a medical condition (or for whom it is medically inadvisable to attempt) to quit using tobacco products by providing a reasonable alternative standard. Fifth, the plan discloses in all materials describing the terms of the program the availability of a reasonable alternative standard. Thus, the premium surcharge does not violate this section.

Example 6. (i) *Facts*. Same facts as *Example 5*, except the plan accommodates *F* by requiring *F* to view, over a period of 12 months, a 12-hour video series on health problems associated with tobacco use. *F* can avoid the surcharge by complying with this requirement.

(ii) *Conclusion*. In this *Example 6*, the requirement to watch the series of video tapes is a reasonable alternative method for avoiding the surcharge.

(g) *More favorable treatment of individuals with adverse health factors permitted*—(1) *In rules for eligibility*. (i) Nothing in this section prevents a group health plan from establishing more favorable rules for eligibility (described in paragraph (b)(1) of this section) for individuals with an adverse health factor, such as disability, than for individuals without the adverse health factor. Moreover, nothing in this section prevents a plan from charging a higher premium or contribution with respect to individuals with an adverse health factor if they would not be eligible for the coverage were it not for the adverse health factor. (However, other laws, including State insurance laws, may set or limit premium rates; these laws are not affected by this section.)

(ii) The rules of this paragraph (g)(1) are illustrated by the following examples:

Example 1. (i) *Facts*. An employer sponsors a group health plan that generally is available to employees, spouses of employees, and dependent children until age 23. However, dependent children who are disabled are eligible for coverage beyond age 23.

(ii) *Conclusion*. In this *Example 1*, the plan provision allowing coverage for disabled dependent children beyond age 23 satisfies this paragraph (g)(1) (and thus does not violate this section).

Example 2. (i) *Facts*. An employer sponsors a group health plan, which is generally available to employees (and members of the employee's family) until the last day of the month in which the employee ceases to perform services for the employer. The plan generally charges employees $50 per month for employee-only coverage and $125 per month for family coverage. However, an employee who ceases to perform services for the employer by reason of disability may remain covered under the plan until the last day of the month that is 12 months after the month in which the employee ceased to perform services for the employer. During this extended period of coverage, the plan charges the employee $100 per month for employee-only coverage and $250 per month for family coverage. (This extended period of coverage is without regard to whatever rights the employee (or members of the employee's family) may have for COBRA continuation coverage.)

(ii) *Conclusion*. In this *Example 2*, the plan provision allowing extended coverage for disabled employees and their families satisfies this paragraph (g)(1) (and thus does not violate this section). In addition, the plan is permitted, under this paragraph (g)(1), to charge the disabled employees a higher premium during the extended period of coverage.

Example 3. (i) *Facts*. To comply with the requirements of a COBRA continuation provision, a group health plan generally makes COBRA continuation coverage available for a maximum period of 18 months in connection with a termination of employment but makes the coverage available for a maximum period of 29 months to certain disabled individuals and certain members of the disabled individual's family. Although the plan generally requires payment of 102 percent of the applicable premium for the first 18 months of COBRA continuation coverage, the plan requires payment of 150 percent of the applicable premium for the disabled individual's COBRA continuation coverage during the disability extension if the disabled individual would not be entitled to COBRA continuation coverage but for the disability.

(ii) *Conclusion*. In this *Example 3*, the plan provision allowing extended COBRA continuation coverage for disabled individuals satisfies this paragraph (g)(1) (and thus does not violate this section). In addition, the plan is permitted, under this paragraph (g)(1), to charge the disabled individuals a higher premium for the extended coverage if the individuals would not be eligible for COBRA continuation coverage were it not for the disability. (Similarly, if the plan provided an extended period of coverage for disabled individuals pursuant to State law or plan provision rather than pursuant to a COBRA continuation coverage provision, the plan could likewise charge the disabled individuals a higher premium for the extended coverage.)

(2) *In premiums or contributions*—(i) Nothing in this section prevents a group health plan from charging individuals a premium or contribution that is less than the premium (or contribution) for similarly situated individuals if the lower charge is based on an adverse health factor, such as disability.

(ii) The rules of this paragraph (g)(2) are illustrated by the following example:

Example. (i) *Facts*. Under a group health plan, employees are generally required to pay $50 per month for employee-only coverage and $125 per month for family coverage under the plan. However, employees who are disabled receive coverage (whether employee-only or family coverage) under the plan free of charge.

(ii) *Conclusion*. In this *Example*, the plan provision waiving premium payment for disabled employees is permitted under this paragraph (g)(2) (and thus does not violate this section).

(h) *No effect on other laws*. Compliance with this section is not determinative of compliance with any provision of ERISA (including the COBRA continuation provisions) or any other State or Federal law, such as the Americans with Disabilities Act. Therefore, although the rules of this section would not prohibit a plan from treating one group of similarly situated individuals differently from another (such as providing different benefit packages to current and former employees), other Federal or State laws may require that two separate groups of similarly situated individuals be treated the same for certain purposes (such as making the same benefit package available to COBRA qualified beneficiaries as is made available to active employees). In addition, although this section generally does not impose new disclosure obligations on plans, this section does not affect any other laws, including those that require accurate disclosures and prohibit intentional misrepresentation.

(i) *Applicability dates*. This section applies for plan years beginning on or after July 1, 2007.

[T.D. 9298, 71 FR 75030, Dec. 13, 2006; 72 FR 7929, Feb. 22, 2007, as amended by T.D. 9464, 74 FR 51678, Oct. 7, 2009]

§ 54.9802–2 Special rules for certain church plans.

(a) *Exception for certain church plans*—(1) *Church plans in general*. A church plan described in paragraph (b) of this section is not treated as failing to meet the requirements of section 9802 or § 54.9802–1 solely because the plan requires evidence of good health for coverage of individuals under plan provisions described in paragraph (b)(2) or (3) of this section.

(2) *Health insurance issuers*. See sections 2702 and 2721(b)(1)(B) of the Public Health Service Act (42 U.S.C. 300gg–2 and 300gg–21(b)(1)(B)) and 45 CFR 146.121, which require health insurance issuers providing health insurance coverage under a church plan that is a group health plan to comply with nondiscrimination requirements similar to those that church plans are required to comply with under section 9802 and § 54.9802–1 except that those nondiscrimination requirements do not include an exception for health insurance issuers comparable to the exception for church plans under section 9802(c) and this section.

(b) *Church plans to which this section applies*—(1) *Church plans with certain coverage provisions in effect on July 15, 1997*. This section applies to any church plan (as defined in section 414(e)) for a plan year if, on July 15, 1997 and at all times thereafter before the beginning of the plan year, the plan contains either the provisions described in paragraph (b)(2) of this section or the provisions described in paragraph (b)(3) of this section.

(2) *Plan provisions applicable to individuals employed by employers of 10 or*

fewer employees and self-employed individuals. (i) A plan contains the provisions described in this paragraph (b)(2) if it requires evidence of good health of both—

(A) Any employee of an employer of 10 or fewer employees (determined without regard to section 414(e)(3)(C), under which a church or convention or association of churches is treated as the employer); and

(B) Any self-employed individual.

(ii) A plan does not contain the provisions described in this paragraph (b)(2) if the plan contains only one of the provisions described in this paragraph (b)(2). Thus, for example, a plan that requires evidence of good health of any self-employed individual, but not of any employee of an employer with 10 or fewer employees, does not contain the provisions described in this paragraph (b)(2). Moreover, a plan does not contain the provision described in paragraph (b)(2)(i)(A) of this section if the plan requires evidence of good health of any employee of an employer of fewer than 10 (or greater than 10) employees. Thus, for example, a plan does not contain the provision described in paragraph (b)(2)(i)(A) of this section if the plan requires evidence of good health of any employee of an employer with five or fewer employees.

(3) *Plan provisions applicable to individuals who enroll after the first 90 days of initial eligibility*. (i) A plan contains the provisions described in this paragraph (b)(3) if it requires evidence of good health of any individual who enrolls after the first 90 days of initial eligibility under the plan.

(ii) A plan does not contain the provisions described in this paragraph (b)(3) if it provides for a longer (or shorter) period than 90 days. Thus, for example, a plan requiring evidence of good health of any individual who enrolls after the first 120 days of initial eligibility under the plan does not contain the provisions described in this paragraph (b)(3).

(c) *Examples*. The rules of this section are illustrated by the following examples:

Example 1. (i) *Facts*. A church organization maintains two church plans for entities affiliated with the church. One plan is a group health plan that provides health coverage to all employees (including ministers and lay workers) of any affiliated church entity that has more than 10 employees. The other plan is Plan *O*, which is a group health plan that is not funded through insurance coverage and that provides health coverage to any employee (including ministers and lay workers) of any affiliated church entity that has 10 or fewer employees and any self-employed individual affiliated with the church (including a self-employed minister of the church). Plan *O* requires evidence of good health in order for any individual of a church entity that has 10 or fewer employees to be covered and in order for any self-employed individual to be covered. On July 15, 1997 and at all times thereafter before the beginning of the plan year, Plan *O* has contained all the preceding provisions.

(ii) *Conclusion*. In this *Example 1*, because Plan *O* contains the plan provisions described in paragraph (b)(2) of this section and because those provisions were in the plan on July 15, 1997 and at all times thereafter before the beginning of the plan year, Plan *O* will not be treated as failing to meet the requirements of section 9802 or § 54.9802–1 for the plan year solely because the plan requires evidence of good health for coverage of the individuals described in those plan provisions.

Example 2. (i) *Facts*. A church organization maintains Plan *P*, which is a church plan that is not funded through insurance coverage and that is a group health plan providing health coverage to individuals employed by entities affiliated with the church and self-employed individuals affiliated with the church (such as ministers). On July 15, 1997 and at all times thereafter before the beginning of the plan year, Plan *P* has required evidence of good health for coverage of any individual who enrolls after the first 90 days of initial eligibility under the plan.

(ii) *Conclusion*. In this *Example 2*, because Plan P contains the plan provisions described in paragraph (b)(3) of this section and because those provisions were in the plan on July 15, 1997 and at all times thereafter before the beginning of the plan year, Plan *P* will not be treated as failing to meet the requirements of section 9802 or § 54.9802–1 for the plan year solely because the plan requires evidence of good health for coverage of individuals enrolling after the first 90 days of initial eligibility under the plan.

(d) *Applicability date*. This section is applicable to plan years beginning on or after July 1, 2007.

[T.D. 9299, 71 FR 75056, Dec. 13, 2006]

§ 54.9802–3T Additional requirements prohibiting discrimination based on genetic information (temporary).

(a) *Definitions*. Unless otherwise provided, the definitions in this paragraph (a) govern in applying the provisions of this section.

(1) *Collect* means, with respect to information, to request, require, or purchase such information.

(2) *Family member* means, with respect to an individual —

(i) A dependent (as defined for purposes of § 54.9801–2) of the individual; or

(ii) Any other person who is a first-degree, second-degree, third-degree, or fourth-degree relative of the individual or of a dependent of the individual. Relatives by affinity (such as by marriage or adoption) are treated the same as relatives by consanguinity (that is, relatives who share a common biological ancestor). In determining the degree of the relationship, relatives by less than full consanguinity (such as half-siblings, who share only one parent) are treated the same as relatives by full consanguinity (such as siblings who share both parents).

(A) First-degree relatives include parents, spouses, siblings, and children.

(B) Second-degree relatives include grandparents, grandchildren, aunts, uncles, nephews, and nieces.

(C) Third-degree relatives include great-grandparents, great-grandchildren, great aunts, great uncles, and first cousins.

(D) Fourth-degree relatives include great-great grandparents, great-great grandchildren, and children of first cousins.

(3) *Genetic information* means—

(i) Subject to paragraphs (a)(3)(ii) and (a)(3)(iii) of this section, with respect to an individual, information about—

(A) The individual's genetic tests (as defined in paragraph (a)(5) of this section);

(B) The genetic tests of family members of the individual;

(C) The manifestation (as defined in paragraph (a)(6) of this section) of a disease or disorder in family members of the individual; or

(D) Any request for, or receipt of, genetic services (as defined in paragraph (a)(4) of this section), or participation in clinical research which includes genetic services, by the individual or any family member of the individual.

(ii) The term *genetic information* does not include information about the sex or age of any individual.

(iii) The term *genetic information* includes—

(A) With respect to a pregnant woman (or a family member of the pregnant woman), genetic information of any fetus carried by the pregnant woman; and

(B) With respect to an individual (or a family member of the individual) who is utilizing an assisted reproductive technology, genetic information of any embryo legally held by the individual or family member.

(4) *Genetic services* means—

(i) A genetic test, as defined in paragraph (a)(5) of this section;

(ii) Genetic counseling (including obtaining, interpreting, or assessing genetic information); or

(iii) Genetic education.

(5)(i) *Genetic test* means an analysis of human DNA, RNA, chromosomes, proteins, or metabolites, if the analysis detects genotypes, mutations, or chromosomal changes. However, a genetic test does not include an analysis of proteins or metabolites that is directly related to a manifested disease, disorder, or pathological condition. Accordingly, a test to determine whether an individual has a BRCA1 or BRCA2 variant is a genetic test. Similarly, a test to determine whether an individual has a genetic variant associated with hereditary nonpolyposis colorectal cancer is a genetic test. However, an HIV test, complete blood count, cholesterol test, liver function test, or test for the presence of alcohol or drugs is not a genetic test.

(ii) The rules of this paragraph (a)(5) are illustrated by the following example:

Example. (i) *Facts*. Individual A is a newborn covered under a group health plan. A undergoes a phenylketonuria (PKU) screening, which measures the concentration of a metabolite, phenylalanine, in A's blood. In PKU, a mutation occurs in the phenylalanine hydroxylase (PAH) gene which contains instructions for making the enzyme needed to break down the amino acid phenylalanine. Individuals with the mutation, who have a deficiency in the enzyme to

break down phenylalanine, have high concentrations of phenylalanine.

(ii) *Conclusion.* In this *Example,* the PKU screening is a genetic test with respect to A because the screening is an analysis of metabolites that detects a genetic mutation.

(6)(i) *Manifestation* or *manifested* means, with respect to a disease, disorder, or pathological condition, that an individual has been or could reasonably be diagnosed with the disease, disorder, or pathological condition by a health care professional with appropriate training and expertise in the field of medicine involved. For purposes of this section, a disease, disorder, or pathological condition is not manifested if a diagnosis is based principally on genetic information.

(ii) The rules of this paragraph (a)(6) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual A has a family medical history of diabetes. A begins to experience excessive sweating, thirst, and fatigue. A's physician examines A and orders blood glucose testing (which is not a genetic test). Based on the physician's examination, A's symptoms, and test results that show elevated levels of blood glucose, A's physician diagnoses A as having adult onset diabetes mellitus (Type 2 diabetes).

(ii) *Conclusion.* In this *Example 1,* A has been diagnosed by a health care professional with appropriate training and expertise in the field of medicine involved. The diagnosis is not based principally on genetic information. Thus, Type 2 diabetes is manifested with respect to A.

Example 2. (i) *Facts.* Individual B has several family members with colon cancer. One of them underwent genetic testing which detected a mutation in the MSH2 gene associated with hereditary nonpolyposis colorectal cancer (HNPCC). B's physician, a health care professional with appropriate training and expertise in the field of medicine involved, recommends that B undergo a targeted genetic test to look for the specific mutation found in B's relative to determine if B has an elevated risk for cancer. The genetic test with respect to B showed that B also carries the mutation and is at increased risk to develop colorectal and other cancers associated with HNPCC. B has a colonoscopy which indicates no signs of disease, and B has no symptoms.

(ii) *Conclusion.* In this *Example 2,* because B has no signs or symptoms of colorectal cancer, B has not been and could not reasonably be diagnosed with HNPCC. Thus, HNPCC is not manifested with respect to B.

Example 3. (i) *Facts.* Same facts as *Example 2,* except that B's colonoscopy and subsequent tests indicate the presence of HNPCC. Based on the colonoscopy and subsequent test results, B's physician makes a diagnosis of HNPCC.

(ii) Conclusion. In this *Example 3,* HNPCC is manifested with respect to B because a health care professional with appropriate training and expertise in the field of medicine involved has made a diagnosis that is not based principally on genetic information.

Example 4. (i) *Facts.* Individual C has a family member that has been diagnosed with Huntington's Disease. A genetic test indicates that C has the Huntington's Disease gene variant. At age 42, C begins suffering from occasional moodiness and disorientation, symptoms which are associated with Huntington's Disease. C is examined by a neurologist (a physician with appropriate training and expertise for diagnosing Huntington's Disease). The examination includes a clinical neurological exam. The results of the examination do not support a diagnosis of Huntington's Disease.

(ii) *Conclusion.* In this *Example 4,* C is not and could not reasonably be diagnosed with Huntington's Disease by a health care professional with appropriate training and expertise. Therefore, Huntington's Disease is not manifested with respect to C.

Example 5. (i) *Facts.* Same facts as *Example 4,* except that C exhibits additional neurological and behavioral symptoms, and the results of the examination support a diagnosis of Huntington's Disease with respect to C.

(ii) *Conclusion.* In this *Example 5,* C could reasonably be diagnosed with Huntington's Disease by a health care professional with appropriate training and expertise. Therefore, Huntington's Disease is manifested with respect to C.

(7) *Underwriting purposes* has the meaning given in paragraph (d)(1) of this section.

(b) *No group-based discrimination based on genetic information*—(1) *In general.* For purposes of this section, a group health plan must not adjust premium or contribution amounts for any employer, or any group of similarly situated individuals under the plan, on the basis of genetic information. For this purpose, ''similarly situated individuals'' are those described in § 54.9802–1(d).

(2) *Rule of construction.* Nothing in paragraph (b)(1) of this section (or in paragraph (d)(1) or (d)(2) of this section) limits the ability of a group health plan to increase the premium for an employer or for a group of similarly situated individuals under the plan based on the manifestation of a

disease or disorder of an individual who is enrolled in the plan. In such a case, however, the manifestation of a disease or disorder in one individual cannot also be used as genetic information about other group members to further increase the premium for an employer or a group of similarly situated individuals under the plan.

(3) *Examples*. The rules of this paragraph (b) are illustrated by the following examples:

Example 1. (i) *Facts*. An employer sponsors a group health plan that provides coverage through a health insurance issuer. In order to determine the premium rate for the upcoming plan year, the issuer reviews the claims experience of individuals covered under the plan and other health status information of the individuals, including genetic information. The issuer finds that three individuals covered under the plan had unusually high claims experience. In addition, the issuer finds that the genetic information of two other individuals indicates the individuals have a higher probability of developing certain illnesses although the illnesses are not manifested at this time. The issuer quotes the plan a higher per-participant rate because of both the genetic information and the higher claims experience.

(ii) *Conclusion*. *See Example 1* in 29 CFR 2590.702–1(b)(3) or 45 CFR 146.122(b)(3) for a conclusion that the issuer violates the provisions of 29 CFR 2590.702–1(b) or 45 CFR 146.122(b) similar to the requirements of this paragraph (b) because the issuer adjusts the premium based on genetic information. However, if the adjustment related solely to claims experience, the adjustment would not violate the requirements of 29 CFR 2590.702–1 or 45 CFR 146.122 similar to the requirements of this section (nor would it violate the requirements of paragraph (c) of 29 CFR 2590.702 or 45 CFR 146.121 similar to the requirements of paragraph (c) of § 54.9802–1, which prohibits discrimination in individual premiums or contributions based on a health factor but permits increases in the group rate based on a health factor).

Example 2. (i) *Facts*. An employer sponsors a group health plan that provides coverage through a health insurance issuer. In order to determine the premium rate for the upcoming plan year, the issuer reviews the claims experience of individuals covered under the plan and other health status information of the individuals, including genetic information. The issuer finds that Employee A has made claims for treatment of polycystic kidney disease. A also has two dependent children covered under the plan. The issuer quotes the plan a higher per-participant rate because of both A's claims experience and the family medical history of A's children (that is, the fact that A has the disease).

(ii) *Conclusion*. *See Example 2* in 29 CFR 2590.702–1(b)(3) or 45 CFR 146.122(b)(3) for a conclusion that the issuer violates the provisions of 29 CFR 2590.702–1(b) or 45 CFR 146.122(b) similar to the requirements of this paragraph (b) because, by taking the likelihood that A's children may develop polycystic kidney disease into account in computing the rate for the plan, the issuer adjusts the premium based on genetic information relating to a condition that has not been manifested in A's children. However, the issuer does not violate the requirements of 29 CFR 2590.702–1(b) or 45 CFR 146.122(b) similar to the requirements of this paragraph (b) by increasing the premium based on A's claims experience.

(c) *Limitation on requesting or requiring genetic testing*—(1) *General rule*. Except as otherwise provided in this paragraph (c), a group health plan must not request or require an individual or a family member of the individual to undergo a genetic test.

(2) *Health care professional may recommend a genetic test*. Nothing in paragraph (c)(1) of this section limits the authority of a health care professional who is providing health care services to an individual to request that the individual undergo a genetic test.

(3) *Examples*. The rules of paragraphs (c)(1) and (c)(2) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Individual A goes to a physician for a routine physical examination. The physician reviews A's family medical history and A informs the physician that A's mother has been diagnosed with Huntington's Disease. The physician advises A that Huntington's Disease is hereditary and recommends that A undergo a genetic test.

(ii) *Conclusion*. In this *Example 1*, the physician is a health care professional who is providing health care services to A. Therefore, the physician's recommendation that A undergo the genetic test does not violate this paragraph (c).

Example 2. (i) *Facts*. Individual B is covered by a health maintenance organization (HMO). *B* is a child being treated for leukemia. B's physician, who is employed by the HMO, is considering a treatment plan that includes six-mercaptopurine, a drug for treating leukemia in most children. However, the drug could be fatal if taken by a small percentage of children with a particular gene variant. B's physician recommends that B undergo a genetic test to detect this variant before proceeding with this course of treatment.

(ii) *Conclusion*. In this *Example 2*, even though the physician is employed by the HMO, the physician is nonetheless a health care professional who is providing health care services to B. Therefore, the physician's recommendation that B undergo the genetic test does not violate this paragraph (c).

(4) *Determination regarding payment*—(i) *In general*. As provided in this paragraph (c)(4), nothing in paragraph (c)(1) of this section precludes a plan from obtaining and using the results of a genetic test in making a determination regarding payment. For this purpose, ''payment'' has the meaning given such term in 45 CFR 164.501 of the privacy regulations issued under the Health Insurance Portability and Accountability Act. Thus, if a plan conditions payment for an item or service based on its medical appropriateness and the medical appropriateness of the item or service depends on the genetic makeup of a patient, then the plan is permitted to condition payment for the item or service on the outcome of a genetic test. The plan may also refuse payment if the patient does not undergo the genetic test.

(ii) *Limitation*. A plan is permitted to request only the minimum amount of information necessary to make a determination regarding payment. The minimum amount of information necessary is determined in accordance with the minimum necessary standard in 45 CFR 164.502(b) of the privacy regulations issued under the Health Insurance Portability and Accountability Act.

(iii) *Examples*. *See* paragraph (e) of this section for examples illustrating the rules of this paragraph (c)(4), as well as other provisions of this section.

(5) *Research exception*. Notwithstanding paragraph (c)(1) of this section, a plan may request, but not require, that a participant or beneficiary undergo a genetic test if all of the conditions of this paragraph (c)(5) are met:

(i) *Research in accordance with Federal regulations and applicable State or local law or regulations*. The plan makes the request pursuant to research, as defined in 45 CFR 46.102(d), that complies with 45 CFR Part 46 or equivalent Federal regulations, and any applicable State or local law or regulations for the protection of human subjects in research.

(ii) *Written request for participation in research*. The plan makes the request in writing, and the request clearly indicates to each participant or beneficiary (or, in the case of a minor child, to the legal guardian of the beneficiary) that—

(A) Compliance with the request is voluntary; and

(B) Noncompliance will have no effect on eligibility for benefits (as described in § 54.9802–1(b)(1)) or premium or contribution amounts.

(iii) *Prohibition on underwriting*. No genetic information collected or acquired under this paragraph (c)(5) can be used for underwriting purposes (as described in paragraph (d)(1) of this section).

(iv) *Notice to Federal agencies*. The plan completes a copy of the ''Notice of Research Exception under the Genetic Information Nondiscrimination Act'' authorized by the Secretary and provides the notice to the address specified in the instructions thereto.

(d) *Prohibitions on collection of genetic information*—(1) *For underwriting purposes*—(i) *General rule*. A group health plan must not collect (as defined in paragraph (a)(1) of this section) genetic information for underwriting purposes. *See* paragraph (e) of this section for examples illustrating the rules of this paragraph (d)(1), as well as other provisions of this section.

(ii) *Underwriting purposes defined*. Subject to paragraph (d)(1)(iii) of this section, *underwriting purposes* means, with respect to any group health plan, or health insurance coverage offered in connection with a group health plan—

(A) Rules for, or determination of, eligibility (including enrollment and continued eligibility) for benefits under the plan or coverage as described in § 54.9802–1(b)(1)(ii) (including changes in deductibles or other cost-sharing mechanisms in return for activities such as completing a health risk assessment or participating in a wellness program);

(B) The computation of premium or contribution amounts under the plan or coverage (including discounts, rebates, payments in kind, or other premium differential mechanisms in return for activities such as completing a

health risk assessment or participating in a wellness program);

(C) The application of any preexisting condition exclusion under the plan or coverage; and

(D) Other activities related to the creation, renewal, or replacement of a contract of health insurance or health benefits.

(iii) *Medical appropriateness.* If an individual seeks a benefit under a group health plan, the plan may limit or exclude the benefit based on whether the benefit is medically appropriate, and the determination of whether the benefit is medically appropriate is not within the meaning of underwriting purposes. Accordingly, if an individual seeks a benefit under the plan and the plan conditions the benefit based on its medical appropriateness and the medical appropriateness of the benefit depends on genetic information of the individual, then the plan is permitted to condition the benefit on the genetic information. A plan is permitted to request only the minimum amount of genetic information necessary to determine medical appropriateness. The plan may deny the benefit if the patient does not provide the genetic information required to determine medical appropriateness. If an individual is not seeking a benefit, the medical appropriateness exception of this paragraph (d)(1)(iii) to the definition of underwriting purposes does not apply. *See* paragraph (e) of this section for examples illustrating the medical appropriateness provisions of this paragraph (d)(1)(iii), as well as other provisions of this section.

(2) *Prior to or in connection with enrollment*—(i) *In general.* A group health plan must not collect genetic information with respect to any individual prior to that individual's effective date of coverage under that plan, nor in connection with the rules for eligibility (as defined in § 54.9802–1(b)(1)(ii)) that apply to that individual. Whether or not an individual's information is collected prior to that individual's effective date of coverage is determined at the time of collection.

(ii) *Incidental collection exception*—(A) *In general.* If a group health plan obtains genetic information incidental to the collection of other information concerning any individual, the collection is not a violation of this paragraph (d)(2), as long as the collection is not for underwriting purposes in violation of paragraph (d)(1) of this section.

(B) *Limitation.* The incidental collection exception of this paragraph (d)(2)(ii) does not apply in connection with any collection where it is reasonable to anticipate that health information will be received, unless the collection explicitly states that genetic information should not be provided.

(3) *Examples.* The rules of this paragraph (d) are illustrated by the following examples:

Example 1. (i) *Facts.* A group health plan provides a premium reduction to enrollees who complete a health risk assessment. The health risk assessment is requested to be completed after enrollment. Whether or not it is completed or what responses are given on it has no effect on an individual's enrollment status, or on the enrollment status of members of the individual's family. The health risk assessment includes questions about the individual's family medical history.

(ii) *Conclusion.* In this *Example 1,* the health risk assessment includes a request for genetic information (that is, the individual's family medical history). Because completing the health risk assessment results in a premium reduction, the request for genetic information is for underwriting purposes. Consequently, the request violates the prohibition on the collection of genetic information in paragraph (d)(1) of this section.

Example 2. (i) *Facts.* The same facts as *Example 1,* except there is no premium reduction or any other reward for completing the health risk assessment.

(ii) *Conclusion.* In this *Example 2,* the request is not for underwriting purposes, nor is it prior to or in connection with enrollment. Therefore, it does not violate the prohibition on the collection of genetic information in this paragraph (d).

Example 3. (i) *Facts.* A group health plan requests that enrollees complete a health risk assessment prior to enrollment, and includes questions about the individual's family medical history. There is no reward or penalty for completing the health risk assessment.

(ii) *Conclusion.* In this *Example 3,* because the health risk assessment includes a request for genetic information (that is, the individual's family medical history), and requests the information prior to enrollment, the request violates the prohibition on the collection of genetic information in paragraph (d)(2) of this section. Moreover, because it is a request for genetic information,

it is not an incidental collection under paragraph (d)(2)(ii) of this section.

Example 4. (i) *Facts.* The facts are the same as in *Example 1,* except there is no premium reduction or any other reward given for completion of the health risk assessment. However, certain people completing the health risk assessment may become eligible for additional benefits under the plan by being enrolled in a disease management program based on their answers to questions about family medical history. Other people may become eligible for the disease management program based solely on their answers to questions about their individual medical history.

(ii) *Conclusion.* In this *Example 4,* the request for information about an individual's family medical history could result in the individual being eligible for benefits for which the individual would not otherwise be eligible. Therefore, the questions about family medical history on the health risk assessment are a request for genetic information for underwriting purposes and are prohibited under this paragraph (d). Although the plan conditions eligibility for the disease management program based on determinations of medical appropriateness, the exception for determinations of medical appropriateness does not apply because the individual is not seeking benefits.

Example 5. (i) *Facts.* A group health plan requests enrollees to complete two distinct health risk assessments (HRAs) after and unrelated to enrollment. The first HRA instructs the individual to answer only for the individual and not for the individual's family. The first HRA does not ask about any genetic tests the individual has undergone or any genetic services the individual has received. The plan offers a reward for completing the first HRA. The second HRA asks about family medical history and the results of genetic tests the individual has undergone. The plan offers no reward for completing the second HRA and the instructions make clear that completion of the second HRA is wholly voluntary and will not affect the reward given for completion of the first HRA.

(ii) *Conclusion.* In this *Example 5,* no genetic information is collected in connection with the first HRA, which offers a reward, and no benefits or other rewards are conditioned on the request for genetic information in the second HRA. Consequently, the request for genetic information in the second HRA is not for underwriting purposes, and the two HRAs do not violate the prohibition on the collection of genetic information in this paragraph (d).

Example 6. (i) *Facts.* A group health plan waives its annual deductible for enrollees who complete an HRA. The HRA is requested to be completed after enrollment. Whether or not the HRA is completed or what responses are given on it has no effect on an individual's enrollment status, or on the enrollment status of members of the individual's family. The HRA does not include any direct questions about the individual's genetic information (including family medical history). However, the last question reads, ''Is there anything else relevant to your health that you would like us to know or discuss with you?''

(ii) *Conclusion.* In this *Example 6,* the plan's request for medical information does not explicitly state that genetic information should not be provided. Therefore, any genetic information collected in response to the question is not within the incidental collection exception and is prohibited under this paragraph (d).

Example 7. (i) *Facts.* Same facts as *Example 6,* except that the last question goes on to state, ''In answering this question, you should not include any genetic information. That is, please do not include any family medical history or any information related to genetic testing, genetic services, genetic counseling, or genetic diseases for which you believe you may be at risk.''

(ii) *Conclusion.* In this *Example 7,* the plan's request for medical information explicitly states that genetic information should not be provided. Therefore, any genetic information collected in response to the question is within the incidental collection exception. However, the plan may not use any genetic information it obtains incidentally for underwriting purposes.

Example 8. (i) *Facts.* Issuer M acquires Issuer N. M requests N's records, stating that N should not provide genetic information and should review the records to excise any genetic information. N assembles the data requested by M and, although N reviews it to delete genetic information, the data from a specific region included some individuals' family medical history. Consequently, M receives genetic information about some of N's covered individuals.

(ii) *Conclusion.* In this *Example 8,* M's request for health information explicitly stated that genetic information should not be provided. *See Example 8* in 29 CFR 2590.702–1(d)(3) or 45 CFR 146.122(d)(3) for a conclusion that the collection of genetic information was within the incidental collection exception of 29 CFR 2590.702–1(d)(2)(ii) or 45 CFR 146.122(d)(ii) similar to the incidental exception of paragraph (d)(2)(ii) of this section. *See Example 8* in 29 CFR 2590.702–1(d)(3) or 45 CFR 146.122(d)(3) also for a caveat that M may not use the genetic information it obtained incidentally for underwriting purposes.

(e) *Examples regarding determinations of medical appropriateness.* The application of the rules of paragraphs (c) and

(d) of this section to plan determinations of medical appropriateness is illustrated by the following examples:

Example 1. (i) *Facts.* Individual A's group health plan covers genetic testing for celiac disease for individuals who have family members with this condition. After A's son is diagnosed with celiac disease, A undergoes a genetic test and promptly submits a claim for the test to A's issuer for reimbursement. The issuer asks A to provide the results of the genetic test before the claim is paid.

(ii) *Conclusion. See Example 1* in 29 CFR 2590.702–1(e) or 45 CFR 146.122(e) for a conclusion under the rules of paragraph (c)(4) of 29 CFR 2590.702–1 or 45 CFR 146.122 similar to the rules of paragraph (c)(4) of this section that the issuer is permitted to request only the minimum amount of information necessary to make a decision regarding payment. Because the results of the test are not necessary for the issuer to make a decision regarding the payment of A's claim, the conclusion in *Example 1* in 29 CFR 2590.702–1(e) or 45 CFR 146.122(e) concludes that the issuer's request for the results of the genetic test violates paragraph (c) of 29 CFR 2590.702–1 or 45 CFR 146.122 similar to paragraph (c) of this section.

Example 2. (i) *Facts.* Individual B's group health plan covers a yearly mammogram for participants and beneficiaries starting at age 40, or at age 30 for those with increased risk for breast cancer, including individuals with BRCA1 or BRCA2 gene mutations. B is 33 years old and has the BRCA2 mutation. B undergoes a mammogram and promptly submits a claim to B's plan for reimbursement. Following an established policy, the plan asks B for evidence of increased risk of breast cancer, such as the results of a genetic test or a family history of breast cancer, before the claim for the mammogram is paid. This policy is applied uniformly to all similarly situated individuals and is not directed at individuals based on any genetic information.

(ii) *Conclusion.* In this *Example 2,* the plan does not violate paragraphs (c) or (d) of this section. Under paragraph (c), the plan is permitted to request and use the results of a genetic test to make a determination regarding payment, provided the plan requests only the minimum amount of information necessary. Because the medical appropriateness of the mammogram depends on the genetic makeup of the patient, the minimum amount of information necessary includes the results of the genetic test. Similarly, the plan does not violate paragraph (d) of this section because the plan is permitted to request genetic information in making a determination regarding the medical appropriateness of a claim if the genetic information is necessary to make the determination (and if the genetic information is not used for underwriting purposes).

Example 3. (i) *Facts.* Individual C was previously diagnosed with and treated for breast cancer, which is currently in remission. In accordance with the recommendation of C's physician, C has been taking a regular dose of tamoxifen to help prevent a recurrence. C's group health plan adopts a new policy requiring patients taking tamoxifen to undergo a genetic test to ensure that tamoxifen is medically appropriate for their genetic makeup. In accordance with, at the time, the latest scientific research, tamoxifen is not helpful in up to 7 percent of breast cancer patients, those with certain variations of the gene for making the CYP_2D6 enzyme. If a patient has a gene variant making tamoxifen not medically appropriate, the plan does not pay for the tamoxifen prescription.

(ii) *Conclusion.* In this *Example 3,* the plan does not violate paragraph (c) of this section if it conditions future payments for the tamoxifen prescription on C's undergoing a genetic test to determine what genetic markers C has for making the CYP_2D6 enzyme. Nor does the plan violate paragraph (c) of this section if the plan refuses future payment if the results of the genetic test indicate that tamoxifen is not medically appropriate for C.

Example 4. (i) *Facts.* A group health plan offers a diabetes disease management program to all similarly situated individuals for whom it is medically appropriate based on whether the individuals have or are at risk for diabetes. The program provides enhanced benefits related only to diabetes for individuals who qualify for the program. The plan sends out a notice to all participants that describes the diabetes disease management program and explains the terms for eligibility. Individuals interested in enrolling in the program are advised to contact the plan to demonstrate that they have diabetes or that they are at risk for diabetes. For individuals who do not currently have diabetes, genetic information may be used to demonstrate that an individual is at risk.

(ii) *Conclusion.* In this *Example 4,* the plan may condition benefits under the disease management program upon a showing by an individual that the individual is at risk for diabetes, even if such showing may involve genetic information, provided that the plan requests genetic information only when necessary to make a determination regarding whether the disease management program is medically appropriate for the individual and only requests the minimum amount of information necessary to make that determination.

Example 5. (i) *Facts.* Same facts as *Example 4,* except that the plan includes a questionnaire that asks about the occurrence of diabetes in members of the individual's family

as part of the notice describing the disease management program.

(ii) *Conclusion*. In this *Example 5*, the plan violates the requirements of paragraph (d)(1) of this section because the requests for genetic information are not limited to those situations in which it is necessary to make a determination regarding whether the disease management program is medically appropriate for the individuals.

Example 6. (i) *Facts*. Same facts as *Example 4*, except the disease management program provides an enhanced benefit in the form of a lower annual deductible to individuals under the program; the lower deductible applies with respect to all medical expenses incurred by the individual. Thus, whether or not a claim relates to diabetes, the individual is provided with a lower deductible based on the individual providing the plan with genetic information.

(ii) *Conclusion*. In this *Example 6*, because the enhanced benefits include benefits not related to the determination of medical appropriateness, making available the enhanced benefits is within the meaning of underwriting purposes. Accordingly, the plan may not request or require genetic information (including family history information) in determining eligibility for enhanced benefits under the program because such a request would be for underwriting purposes and would violate paragraph (d)(1) of this section.

(f) *Effective/applicability date*. This section applies for plan years beginning on or after December 7, 2009.

(g) *Expiration date*. This section expires on or before October 1, 2012.

[T.D. 9464, 74 FR 51678, Oct. 7, 2009]

§ 54.9811–1 Standards relating to benefits for mothers and newborns.

(a) *Hospital length of stay*—(1) *General rule*. Except as provided in paragraph (a)(5) of this section, a group health plan that provides benefits for a hospital length of stay in connection with childbirth for a mother or her newborn may not restrict benefits for the stay to less than—

(i) 48 hours following a vaginal delivery; or

(ii) 96 hours following a delivery by cesarean section.

(2) *When stay begins*—(i) *Delivery in a hospital*. If delivery occurs in a hospital, the hospital length of stay for the mother or newborn child begins at the time of delivery (or in the case of multiple births, at the time of the last delivery).

(ii) *Delivery outside a hospital*. If delivery occurs outside a hospital, the hospital length of stay begins at the time the mother or newborn is admitted as a hospital inpatient in connection with childbirth. The determination of whether an admission is in connection with childbirth is a medical decision to be made by the attending provider.

(3) *Examples*. The rules of paragraphs (a)(1) and (2) of this section are illustrated by the following examples. In each example, the group health plan provides benefits for hospital lengths of stay in connection with childbirth and is subject to the requirements of this section, as follows:

Example 1. (i) *Facts*. A pregnant woman covered under a group health plan goes into labor and is admitted to the hospital at 10 p.m. on June 11. She gives birth by vaginal delivery at 6 a.m. on June 12.

(ii) *Conclusion*. In this *Example 1*, the 48-hour period described in paragraph (a)(1)(i) of this section ends at 6 a.m. on June 14.

Example 2. (i) *Facts*. A woman covered under a group health plan gives birth at home by vaginal delivery. After the delivery, the woman begins bleeding excessively in connection with the childbirth and is admitted to the hospital for treatment of the excessive bleeding at 7 p.m. on October 1.

(ii) *Conclusion*. In this *Example 2*, the 48-hour period described in paragraph (a)(1)(i) of this section ends at 7 p.m. on October 3.

Example 3. (i) *Facts*. A woman covered under a group health plan gives birth by vaginal delivery at home. The child later develops pneumonia and is admitted to the hospital. The attending provider determines that the admission is not in connection with childbirth.

(ii) *Conclusion*. In this *Example 3*, the hospital length-of-stay requirements of this section do not apply to the child's admission to the hospital because the admission is not in connection with childbirth.

(4) *Authorization not required*—(i) *In general*. A plan may not require that a physician or other health care provider obtain authorization from the plan, or from a health insurance issuer offering health insurance coverage under the plan, for prescribing the hospital length of stay specified in paragraph (a)(1) of this section. (See also paragraphs (b)(2) and (c)(3) of this section for rules and examples regarding other authorization and certain notice requirements.)

(ii) *Example*. The rule of this paragraph (a)(4) is illustrated by the following example:

Example. (i) *Facts*. In the case of a delivery by cesarean section, a group health plan subject to the requirements of this section automatically provides benefits for any hospital length of stay of up to 72 hours. For any longer stay, the plan requires an attending provider to complete a certificate of medical necessity. The plan then makes a determination, based on the certificate of medical necessity, whether a longer stay is medically necessary.

(ii) *Conclusion*. In this *Example*, the requirement that an attending provider complete a certificate of medical necessity to obtain authorization for the period between 72 hours and 96 hours following a delivery by cesarean section is prohibited by this paragraph (a)(4).

(5) *Exceptions*—(i) *Discharge of mother*. If a decision to discharge a mother earlier than the period specified in paragraph (a)(1) of this section is made by an attending provider, in consultation with the mother, the requirements of paragraph (a)(1) of this section do not apply for any period after the discharge.

(ii) *Discharge of newborn*. If a decision to discharge a newborn child earlier than the period specified in paragraph (a)(1) of this section is made by an attending provider, in consultation with the mother (or the newborn's authorized representative), the requirements of paragraph (a)(1) of this section do not apply for any period after the discharge.

(iii) *Attending provider defined*. For purposes of this section, attending provider means an individual who is licensed under applicable state law to provide maternity or pediatric care and who is directly responsible for providing maternity or pediatric care to a mother or newborn child. Therefore, a plan, hospital, managed care organization, or other issuer is not an attending provider.

(iv) *Example*. The rules of this paragraph (a)(5) are illustrated by the following example:

Example. (i) *Facts*. A pregnant woman covered under a group health plan subject to the requirements of this section goes into labor and is admitted to a hospital. She gives birth by cesarean section. On the third day after the delivery, the attending provider for the mother consults with the mother, and the attending provider for the newborn consults with the mother regarding the newborn. The attending providers authorize the early discharge of both the mother and the newborn. Both are discharged approximately 72 hours after the delivery. The plan pays for the 72-hour hospital stays.

(ii) *Conclusion*. In this *Example*, the requirements of this paragraph (a) have been satisfied with respect to the mother and the newborn. If either is readmitted, the hospital stay for the readmission is not subject to this section.

(b) *Prohibitions*—(1) *With respect to mothers*—(i) *In general*. A group health plan may not—

(A) Deny a mother or her newborn child eligibility or continued eligibility to enroll or renew coverage under the terms of the plan solely to avoid the requirements of this section; or

(B) Provide payments (including payments-in-kind) or rebates to a mother to encourage her to accept less than the minimum protections available under this section.

(ii) *Examples*. The rules of this paragraph (b)(1) are illustrated by the following examples. In each example, the group health plan is subject to the requirements of this section, as follows:

Example 1. (i) *Facts*. A group health plan provides benefits for at least a 48-hour hospital length of stay following a vaginal delivery. If a mother and newborn covered under the plan are discharged within 24 hours after the delivery, the plan will waive the copayment and deductible.

(ii) *Conclusion*. In this *Example 1*, because waiver of the copayment and deductible is in the nature of a rebate that the mother would not receive if she and her newborn remained in the hospital, it is prohibited by this paragraph (b)(1). (In addition, the plan violates paragraph (b)(2) of this section because, in effect, no copayment or deductible is required for the first portion of the stay and a double copayment and a deductible are required for the second portion of the stay.)

Example 2. (i) *Facts*. A group health plan provides benefits for at least a 48-hour hospital length of stay following a vaginal delivery. In the event that a mother and her newborn are discharged earlier than 48 hours and the discharges occur after consultation with the mother in accordance with the requirements of paragraph (a)(5) of this section, the plan provides for a follow-up visit by a nurse within 48 hours after the discharges to provide certain services that the mother and her newborn would otherwise receive in the hospital.

(ii) *Conclusion*. In this *Example 2*, because the follow-up visit does not provide any services beyond what the mother and her newborn would receive in the hospital, coverage for the follow-up visit is not prohibited by this paragraph (b)(1).

(2) *With respect to benefit restrictions*—(i) *In general*. Subject to paragraph (c)(3) of this section, a group health plan may not restrict the benefits for any portion of a hospital length of stay specified in paragraph (a) of this section in a manner that is less favorable than the benefits provided for any preceding portion of the stay.

(ii) *Example*. The rules of this paragraph (b)(2) are illustrated by the following example:

Example. (i) *Facts*. A group health plan subject to the requirements of this section provides benefits for hospital lengths of stay in connection with childbirth. In the case of a delivery by cesarean section, the plan automatically pays for the first 48 hours. With respect to each succeeding 24-hour period, the participant or beneficiary must call the plan to obtain precertification from a utilization reviewer, who determines if an additional 24-hour period is medically necessary. If this approval is not obtained, the plan will not provide benefits for any succeeding 24-hour period.

(ii) *Conclusion*. In this *Example*, the requirement to obtain precertification for the two 24-hour periods immediately following the initial 48-hour stay is prohibited by this paragraph (b)(2) because benefits for the latter part of the stay are restricted in a manner that is less favorable than benefits for a preceding portion of the stay. (However, this section does not prohibit a plan from requiring precertification for any period after the first 96 hours.) In addition, the requirement to obtain precertification from the plan based on medical necessity for a hospital length of stay within the 96-hour period would also violate paragraph (a) of this section.

(3) *With respect to attending providers*. A group health plan may not directly or indirectly—

(i) Penalize (for example, take disciplinary action against or retaliate against), or otherwise reduce or limit the compensation of, an attending provider because the provider furnished care to a participant or beneficiary in accordance with this section; or

(ii) Provide monetary or other incentives to an attending provider to induce the provider to furnish care to a participant or beneficiary in a manner inconsistent with this section, including providing any incentive that could induce an attending provider to discharge a mother or newborn earlier than 48 hours (or 96 hours) after delivery.

(c) *Construction*. With respect to this section, the following rules of construction apply:

(1) *Hospital stays not mandatory*. This section does not require a mother to—

(i) Give birth in a hospital; or

(ii) Stay in the hospital for a fixed period of time following the birth of her child.

(2) *Hospital stay benefits not mandated*. This section does not apply to any group health plan that does not provide benefits for hospital lengths of stay in connection with childbirth for a mother or her newborn child.

(3) *Cost-sharing rules*—(i) *In general*. This section does not prevent a group health plan from imposing deductibles, coinsurance, or other cost-sharing in relation to benefits for hospital lengths of stay in connection with childbirth for a mother or a newborn under the plan or coverage, except that the coinsurance or other cost-sharing for any portion of the hospital length of stay specified in paragraph (a) of this section may not be greater than that for any preceding portion of the stay.

(ii) *Examples*. The rules of this paragraph (c)(3) are illustrated by the following examples. In each example, the group health plan is subject to the requirements of this section, as follows:

Example 1. (i) *Facts*. A group health plan provides benefits for at least a 48-hour hospital length of stay in connection with vaginal deliveries. The plan covers 80 percent of the cost of the stay for the first 24-hour period and 50 percent of the cost of the stay for the second 24-hour period. Thus, the coinsurance paid by the patient increases from 20 percent to 50 percent after 24 hours.

(ii) *Conclusion*. In this *Example 1*, the plan violates the rules of this paragraph (c)(3) because coinsurance for the second 24-hour period of the 48-hour stay is greater than that for the preceding portion of the stay. (In addition, the plan also violates the similar rule in paragraph (b)(2) of this section.)

Example 2. (i) *Facts*. A group health plan generally covers 70 percent of the cost of a hospital length of stay in connection with childbirth. However, the plan will cover 80 percent of the cost of the stay if the participant or beneficiary notifies the plan of the

pregnancy in advance of admission and uses whatever hospital the plan may designate.

(ii) *Conclusion*. In this *Example 2*, the plan does not violate the rules of this paragraph (c)(3) because the level of benefits provided (70 percent or 80 percent) is consistent throughout the 48-hour (or 96-hour) hospital length of stay required under paragraph (a) of this section. (In addition, the plan does not violate the rules in paragraph (a)(4) or (b)(2) of this section.)

(4) *Compensation of attending provider*. This section does not prevent a group health plan from negotiating with an attending provider the level and type of compensation for care furnished in accordance with this section (including paragraph (b) of this section).

(d) *Notice requirement*. See 29 CFR 2520.102–3(u) for rules relating to a disclosure requirement imposed under section 711(d) of ERISA (29 U.S.C. 1181) on certain group health plans that provide benefits for hospital lengths of stay in connection with childbirth.

(e) *Applicability in certain states*—(1) *Health insurance coverage*. The requirements of section 9811 and this section do not apply with respect to health insurance coverage offered in connection with a group health plan if there is a state law regulating the coverage that meets any of the following criteria:

(i) The state law requires the coverage to provide for at least a 48-hour hospital length of stay following a vaginal delivery and at least a 96-hour hospital length of stay following a delivery by cesarean section.

(ii) The state law requires the coverage to provide for maternity and pediatric care in accordance with guidelines that relate to care following childbirth established by the American College of Obstetricians and Gynecologists, the American Academy of Pediatrics, or any other established professional medical association.

(iii) The state law requires, in connection with the coverage for maternity care, that the hospital length of stay for such care is left to the decision of (or is required to be made by) the attending provider in consultation with the mother. State laws that require the decision to be made by the attending provider with the consent of the mother satisfy the criterion of this paragraph (e)(1)(iii).

(2) *Group health plans*—(i) *Fully-insured plans*. For a group health plan that provides benefits solely through health insurance coverage, if the state law regulating the health insurance coverage meets any of the criteria in paragraph (e)(1) of this section, then the requirements of section 9811 and this section do not apply.

(ii) *Self-insured plans*. For a group health plan that provides all benefits for hospital lengths of stay in connection with childbirth other than through health insurance coverage, the requirements of section 9811 and this section apply.

(iii) *Partially-insured plans*. For a group health plan that provides some benefits through health insurance coverage, if the state law regulating the health insurance coverage meets any of the criteria in paragraph (e)(1) of this section, then the requirements of section 9811 and this section apply only to the extent the plan provides benefits for hospital lengths of stay in connection with childbirth other than through health insurance coverage.

(3) *Preemption provisions under section 731(a) of ERISA*. See 29 CFR 2590.711(e)(3) for a rule providing that the preemption provisions contained in section 731(a)(1) of ERISA and 29 CFR 2590.731(a) do not supersede a state law if the state law is described in paragraph (e)(1) of 29 CFR 2590.711 (which is substantially similar to paragraph (e)(1) of this section).

(4) *Examples*. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts*. A group health plan buys group health insurance coverage in a state that requires that the coverage provide for at least a 48-hour hospital length of stay following a vaginal delivery and at least a 96-hour hospital length of stay following a delivery by cesarean section.

(ii) *Conclusion*. In this *Example 1*, the coverage is subject to state law, and the requirements of section 9811 and this section do not apply.

Example 2. (i) *Facts*. A self-insured group health plan covers hospital lengths of stay in connection with childbirth in a state that requires health insurance coverage to provide

for maternity and pediatric care in accordance with guidelines that relate to care following childbirth established by the American College of Obstetricians and Gynecologists and the American Academy of Pediatrics.

(ii) *Conclusion*. In this *Example 2*, even though the state law satisfies the criterion of paragraph (e)(1)(ii) of this section, because the plan provides benefits for hospital lengths of stay in connection with childbirth other than through health insurance coverage, the plan is subject to the requirements of section 9811 and this section.

(f) *Effective/applicability date*. This section applies to group health plans for plan years beginning on or after January 1, 2009.

[T.D. 9427, 73 FR 62420, Oct. 20, 2008]

§ 54.9812–1T Parity in the application of certain limits to mental health benefits (temporary).

(a) *Definitions*. For purposes of this section, except where the context clearly indicates otherwise, the following definitions apply:

Aggregate lifetime limit means a dollar limitation on the total amount of specified benefits that may be paid under a group health plan for an individual (or for a group of individuals considered a single unit in applying this dollar limitation, such as a family or an employee plus spouse).

Annual limit means a dollar limitation on the total amount of specified benefits that may be paid in a 12-month period under a plan for an individual (or for a group of individuals considered a single unit in applying this dollar limitation, such as a family or an employee plus spouse).

Medical/surgical benefits means benefits for medical or surgical services, as defined under the terms of the plan, but does not include mental health benefits.

Mental health benefits means benefits for mental health services, as defined under the terms of the plan, but does not include benefits for treatment of substance abuse or chemical dependency.

(b) *Requirements regarding limits on benefits*—(1) *In general*—(i) *General parity requirement*. A group health plan that provides both medical/surgical benefits and mental health benefits must comply with paragraph (b) (2), (3), or (6) of this section.

(ii) Exception. The rule in paragraph (b)(1)(i) of this section does not apply if a plan satisfies the requirements of paragraph (e) or (f) of this section.

(2) *Plan with no limit or limits on less than one-third of all medical/surgical benefits*. If a plan does not include an aggregate lifetime or annual limit on any medical/surgical benefits or includes aggregate lifetime or annual limits that apply to less than one-third of all medical/surgical benefits, it may not impose an aggregate lifetime or annual limit, respectively, on mental health benefits.

(3) *Plan with a limit on at least two-thirds of all medical/surgical benefits*. If a plan includes an aggregate lifetime or annual limit on at least two-thirds of all medical/surgical benefits, it must either—

(i) Apply the aggregate lifetime or annual limit both to the medical/surgical benefits to which the limit would otherwise apply and to mental health benefits in a manner that does not distinguish between the medical/surgical and mental health benefits; or

(ii) Not include an aggregate lifetime or annual limit on mental health benefits that is less than the aggregate lifetime or annual limit, respectively, on the medical/surgical benefits.

(4) *Examples*. The rules of paragraphs (b)(2) and (3) of this section are illustrated by the following examples:

Example 1. (i) Prior to the effective date of the mental health parity provisions, a group health plan had no annual limit on medical/surgical benefits and had a $10,000 annual limit on mental health benefits. To comply with the parity requirements of this paragraph (b), the plan sponsor is considering each of the following options:

(A) Eliminating the plan's annual limit on mental health benefits;

(B) Replacing the plan's previous annual limit on mental health benefits with a $500,000 annual limit on all benefits (including medical/surgical and mental health benefits); and

(C) Replacing the plan's previous annual limit on mental health benefits with a $250,000 annual limit on medical/surgical benefits and a $250,000 annual limit on mental health benefits.

(ii) In this *Example 1*, each of the three options being considered by the plan sponsor would comply with the requirements of this

section because they offer parity in the dollar limits placed on medical/surgical and mental health benefits.

Example 2. (i) Prior to the effective date of the mental health parity provisions, a group health plan had a $100,000 annual limit on medical/surgical inpatient benefits, a $50,000 annual limit on medical/surgical outpatient benefits, and a $100,000 annual limit on all mental health benefits. To comply with the parity requirements of this paragraph (b), the plan sponsor is considering each of the following options:

(A) Replacing the plan's previous annual limit on mental health benefits with a $150,000 annual limit on mental health benefits; and

(B) Replacing the plan's previous annual limit on mental health benefits with a $100,000 annual limit on mental health inpatient benefits and a $50,000 annual limit on mental health outpatient benefits.

(ii) In this *Example 2,* each option under consideration by the plan sponsor would comply with the requirements of this section because they offer parity in the dollar limits placed on medical/surgical and mental health benefits.

Example 3. (i) A group health plan that is subject to the requirements of this section has no aggregate lifetime or annual limit for either medical/surgical benefits or mental health benefits. While the plan provides medical/surgical benefits with respect to both network and out-of-network providers, it does not provide mental health benefits with respect to out-of-network providers.

(ii) In this *Example 3,* the plan complies with the requirements of this section because they offer parity in the dollar limits placed on medical/surgical and mental health benefits.

Example 4. (i) Prior to the effective date of the mental health parity provisions, a group health plan had an annual limit on medical/surgical benefits and a separate but identical annual limit on mental health benefits. The plan included benefits for treatment of substance abuse and chemical dependency in its definition of mental health benefits. Accordingly, claims paid for treatment of substance abuse and chemical dependency were counted in applying the annual limit on mental health benefits. To comply with the parity requirements of this paragraph (b), the plan sponsor is considering each of the following options:

(A) Making no change in the plan so that claims paid for treatment of substance abuse and chemical dependency continue to count in applying the annual limit on mental health benefits;

(B) Amending the plan to count claims paid for treatment of substance abuse and chemical dependency in applying the annual limit on medical/surgical benefits (rather than counting those claims in applying the annual limit on mental health benefits);

(C) Amending the plan to provide a new category of benefits for treatment of chemical dependency and substance abuse that is subject to a separate, lower limit and under which claims paid for treatment of substance abuse and chemical dependency are counted only in applying the annual limit on this separate category; and

(D) Amending the plan to eliminate distinctions between medical/surgical benefits and mental health benefits and establishing an overall limit on benefits offered under the plan under which claims paid for treatment of substance abuse and chemical dependency are counted with medical/surgical benefits and mental health benefits in applying the overall limit.

(ii) In this *Example 4,* the group health plan is described in paragraph (b)(3) of this section. Because mental health benefits are defined in paragraph (a) of this section as excluding benefits for treatment of substance abuse and chemical dependency, the inclusion of benefits for treatment of substance abuse and chemical dependency in applying an aggregate lifetime limit or annual limit on mental health benefits under option (A) of this *Example 4* would not comply with the requirements of paragraph (b)(3) of this section. However, options (B), (C), and (D) of this *Example 4.* Would comply with the requirements of paragraph (b)(3) of this section because they offer parity in the dollar limits placed on medical/surgical and mental health benefits.

(5) *Determining one-third and two-thirds of all medical/surgical benefits.* For purposes of this paragraph (b), the determination of whether the portion of medical/surgical benefits subject to a limit represents one-third or two-thirds of all medical/surgical benefits is based on the dollar amount of all plan payments for medical/surgical benefits expected to be paid under the plan for the plan year (or for the portion of the plan year after a change in plan benefits that affects the applicability of the aggregate lifetime or annual limits). Any reasonable method may be used to determine whether the dollar amounts expected to be paid under the plan will constitute one-third or two-thirds of the dollar amount of all plan payments for medical/surgical benefits.

(6) *Plan not described in paragraph (b)(2) or (3) of this section*—(i) *In general.* A group health plan that is not described in paragraph (b)(2) or (3) of this section, must either—

(A) Impose no aggregate lifetime or annual limit, as appropriate, on mental health benefits; or

(B) Impose an aggregate lifetime or annual limit on mental health benefits that is no less than an average limit for medical/surgical benefits calculated in the following manner. The average limit is calculated by taking into account the weighted average of the aggregate lifetime or annual limits, as appropriate, that are applicable to the categories of medical/surgical benefits. Limits based on delivery systems, such as inpatient/outpatient treatment or normal treatment of common, low-cost conditions (such as treatment of normal births), do not constitute categories for purposes of this paragraph (b)(6)(i)(B). In addition, for purposes of determining weighted averages, any benefits that are not within a category that is subject to a separately-designated limit under the plan are taken into account as a single separate category by using an estimate of the upper limit on the dollar amount that a plan may reasonably be expected to incur with respect to such benefits, taking into account any other applicable restrictions under the plan.

(ii) *Weighting*. For purposes of this paragraph (b)(6), the weighting applicable to any category of medical/surgical benefits is determined in the manner set forth in paragraph (b)(5) of this section for determining one-third or two-thirds of all medical/surgical benefits.

(iii) *Example*. The rules of this paragraph (b)(6) are illustrated by the following example:

Example. (i) A group health plan that is subject to the requirements of this section includes a $100,000 annual limit on medical/surgical benefits related to cardio-pulmonary diseases. The plan does not include an annual limit on any other category of medical/surgical benefits. The plan determines that 40% of the dollar amount of plan payments for medical/surgical benefits are related to cardio-pulmonary diseases. The plan determines that $1,000,000 is a reasonable estimate of the upper limit on the dollar amount that the plan may incur with respect to the other 60% of payments for medical/surgical benefits.

(ii) In this *Example*, the plan is not described in paragraph (b)(3) of this section because there is not one annual limit that applies to at least two-thirds of all medical/surgical benefits. Further, the plan is not described in paragraph (b)(2) of this section because more than one-third of all medical/surgical benefits are subject to an annual limit. Under this paragraph (b)(6), the plan sponsor can choose either to include no annual limit on mental health benefits, or to include an annual limit on mental health benefits that is not less than the weighted average of the annual limits applicable to each category of medical/surgical benefits. In this example, the minimum weighted average annual limit that can be applied to mental health benefits is $640,000 (40% × $100,000 + 60% × $1,000,000 = $640,000).

(c) *Rule in the case of separate benefit packages*. If a group health plan offers two or more benefit packages, the requirements of this section, including the exemption provisions in paragraph (f) of this section, apply separately to each benefit package. Examples of a group health plan that offers two or more benefit packages include a group health plan that offers employees a choice between indemnity coverage or HMO coverage, and a group health plan that provides one benefit package for retirees and a different benefit package for current employees.

(d) *Applicability*—(1) *Group health plans*. The requirements of this section apply to a group health plan offering both medical/surgical benefits and mental health benefits regardless of whether the mental health benefits are administered separately under the plan.

(2) *Health insurance issuers*. See 29 CFR 2590.712(d)(2) and 45 CFR 146.136(d)(2), which provide that health insurance issuers offering health insurance coverage for both medical/surgical benefits and mental health benefits in connection with a group health plan are subject to rules similar to those applicable to group health plans under this section.

(3) *Scope*. This section does not—

(i) Require a group health plan to provide any mental health benefits; or

(ii) Affect the terms and conditions (including cost sharing, limits on the number of visits or days of coverage, requirements relating to medical necessity, requiring prior authorization for treatment, or requiring primary

care physicians' referrals for treatment) relating to the amount, duration, or scope of the mental health benefits under the plan except as specifically provided in paragraph (b) of this section.

(e) *Small employer exemption*—(1) *In general*. The requirements of this section do not apply to a group health plan for a plan year of a small employer. For purposes of this paragraph (e), the term *small employer* means, in connection with a group health plan with respect to a calendar year and a plan year, an employer who employed an average of at least two but not more than 50 employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year. See section 9831(a) and §54.9831–1T(a), which provide that this section (and certain other sections) does not apply to any group health plan for any plan year if, on the first day of the plan year, the plan has fewer than two participants who are current employees.

(2) *Rules in determining employer size*. For purposes of paragraph (e)(1) of this section—

(i) All persons treated as a single employer under subsections (b), (c), (m), and (o) of section 414 are treated as one employer;

(ii) If an employer was not in existence throughout the preceding calendar year, whether it is a small employer is determined based on the average number of employees the employer reasonably expects to employ on business days during the current calendar year; and

(iii) Any reference to an employer for purposes of the small employer exemption includes a reference to a predecessor of the employer.

(f) *Increased cost exemption*—(1) *In general*. A group health plan is not subject to the requirements of this section if the requirements of this paragraph (f) are satisfied. If a plan offers more than one benefit package, this paragraph (f) applies separately to each benefit package. Except as provided in paragraph (h) of this section, a plan must comply with the requirements of paragraph (b)(1)(i) of this section for the first plan year beginning on or after January 1, 1998, and must continue to comply with the requirements of paragraph (b)(1)(i) of this section until the plan satisfies the requirements in this paragraph (f). In no event is the exemption of this paragraph (f) effective until 30 days after the notice requirements in paragraph (f)(3) of this section are satisfied. If the requirements of this paragraph (f) are satisfied with respect to a plan, the exemption continues in effect (at the plan's discretion) until September 30, 2001, even if the plan subsequently purchases a different policy from the same or a different issuer and regardless of any other changes to the plan's benefit structure.

(2) *Calculation of the one-percent increase*—(i) *Ratio*. A group health plan satisfies the requirements of this paragraph (f)(2) if the application of paragraph (b)(1)(i) of this section to the plan results in an increase in the cost under the plan of at least one percent. The application of paragraph (b)(1)(i) of this section results in an increased cost of at least one percent under a group health plan only if the ratio below equals or exceeds 1.01000. The ratio is determined as follows:

(A) The incurred expenditures during the base period, divided by,

(B) The incurred expenditures during the base period, reduced by—

(*1*) The claims incurred during the base period that would have been denied under the terms of the plan absent plan amendments required to comply with this section; and

(*2*) Administrative expenses attributable to complying with the requirements of this section.

(ii) *Formula*. The ratio of paragraph (f)(2)(i) of this section is expressed mathematically as follows:

$$\frac{IE}{IE-(CE+AE)} \geq 1.01000$$

(A) *IE* means the incurred expenditures during the base period.

(B) *CE* means the claims incurred during the base period that would have been denied under the terms of the plan absent plan amendments required to comply with this section.

(C) *AE* means administrative costs related to claims in *CE* and other administrative costs attributable to complying with the requirements of this section.

(iii) *Incurred expenditures. Incurred expenditures* means actual claims incurred during the base period and reported within two months following the base period, and administrative costs for all benefits under the group health plan, including mental health benefits and medical/surgical benefits, during the base period. Incurred expenditures do not include premiums.

(iv) *Base period. Base period* means the period used to calculate whether the plan may claim the one-percent increased cost exemption in this paragraph (f). The base period must begin on the first day in any plan year that the plan complies with the requirements of paragraph (b)(1)(i) of this section and must extend for a period of at least six consecutive calendar months. However, in no event may the base period begin prior to September 26, 1996 (the date of enactment of the Mental Health Parity Act (Pub. L. 104–204, 110 Stat. 2944)).

(v) *Rating pools.* For plans that are combined in a pool for rating purposes, the calculation under this paragraph (f)(2) for each plan in the pool for the base period is based on the incurred expenditures of the pool, whether or not all the plans in the pool have participated in the pool for the entire base period. (However, only the plans that have complied with paragraph (b)(1)(i) of this section for at least six months as a member of the pool satisfy the requirements of this paragraph (f)(2).) Otherwise, the calculation under this paragraph (f)(2) for each plan is calculated by the plan administrator based on the incurred expenditures of the plan.

(vi) *Examples.* The rules of this paragraph (f)(2) are illustrated by the following examples:

Example 1. (i) A group health plan has a plan year that is the calendar year. The plan satisfies the requirements of paragraph (b)(1)(i) of this section as of January 1, 1998. On September 15, 1998, the plan determines that $1,000,000 in claims have been incurred during the period between January 1, 1998 and June 30, 1998 and reported by August 30, 1998. The plan also determines that $100,000 in administrative costs have been incurred for all benefits under the group health plan, including mental health benefits. Thus, the plan determines that its incurred expenditures for the base period are $1,100,000. The plan also determines that the claims incurred during the base period that would have been denied under the terms of the plan absent plan amendments required to comply with this section are $40,000 and that administrative expenses attributable to complying with the requirements of this section are $10,000. Thus, the total amount of expenditures for the base period had the plan not been amended to comply with the requirements of paragraph (b)(1)(i) of this section are $1,050,000 ($1,100,000 − ($40,000 + $10,000) = $1,050,000).

(ii) In this *Example 1*, the plan satisfies the requirements of this paragraph (f)(2) because the application of this section results in an increased cost of at least one percent under the terms of the plan ($1,100,000/$1,050,000 = 1.04762).

Example 2. (i) A health insurance issuer sells a group health insurance policy that is rated on a pooled basis and is sold to 30 group health plans. One of the group health plans inquires whether it qualifies for the one-percent increased cost exemption. The issuer performs the calculation for the pool as a whole and determines that the application of this section results in an increased cost of 0.500 percent (for a ratio under this paragraph (f)(2) of 1.00500) for the pool. The issuer informs the requesting plan and the other plans in the pool of the calculation.

(ii) In this *Example 2*, none of the plans satisfy the requirements of this paragraph (f)(2) and a plan that purchases a policy not complying with the requirements of paragraph (b)(1)(i) of this section violates the requirements of this section.

Example 3. (i) A partially insured plan is collecting the information to determine whether it qualifies for the exemption. The plan administrator determines the incurred expenses for the base period for the self-funded portion of the plan to be $2,000,000 and the administrative expenses for the base period for the self-funded portion to be $200,000. For the insured portion of the plan, the plan administrator requests data from the insurer. For the insured portion of the plan, the plan's own incurred expenses for the base period are $1,000,000 and the administrative expenses for the base period are $100,000. The plan administrator determines that under the self-funded portion of the plan, the claims incurred for the base period that would have been denied under the terms of the plan absent the amendment are $0 because the self-funded portion does not cover mental health benefits and the plan's administrative costs attributable to complying with the requirements of this section are $1,000. The issuer determines that under the

insured portion of the plan, the claims incurred for the base period that would have been denied under the terms of the plan absent the amendment are $25,000 and the administrative costs attributable to complying with the requirements of this section are $1,000. Thus, the total incurred expenditures for the plan for the base period are $3,300,000 ($2,000,000 + $200,000 + $1,000,000 + $100,000 = $3,300,000) and the total amount of expenditures for the base period had the plan not been amended to comply with the requirements of paragraph (b)(1)(i) of this section are $3,273,000 ($3,300,000 – ($0 + $1,000 + $25,000 + $1,000) = $3,273,000).

(ii) In this *Example 3*, the plan does not satisfy the requirements of this paragraph (f)(2) because the application of this section does not result in an increased cost of at least one percent under the terms of the plan ($3,300,000/$3,273,000 = 1.00825).

(3) *Notice of exemption*—(i) *Participants and beneficiaries*—(A) *In general.* A group health plan must notify participants and beneficiaries of the plan's decision to claim the one-percent increased cost exemption. The notice must include the following information:

(*1*) A statement that the plan is exempt from the requirements of this section and a description of the basis for the exemption;

(*2*) The name and telephone number of the individual to contact for further information;

(*3*) The plan name and plan number (PN);

(*4*) The plan administrator's name, address, and telephone number;

(*5*) For single-employer plans, the plan sponsor's name, address, and telephone number (if different from paragraph (f)(3)(i)(A)(*3*) of this section) and the plan sponsor's employer identification number (EIN);

(*6*) The effective date of the exemption;

(*7*) The ability of participants and beneficiaries to contact the plan administrator to see how benefits may be affected as a result of the plan's claim of the exemption; and

(*8*) The availability, upon request and free of charge, of a summary of the information required under paragraph (f)(4) of this section.

(B) *Use of summary of material reductions in covered services or benefits.* A plan may satisfy the requirements of paragraph (f)(3)(i)(A) of this section by providing participants and beneficiaries (in accordance with paragraph (f)(3)(i)(C) of this section) with a summary of material reductions in covered services or benefits required under 29 CFR 2520.104b–3(d) that also includes the information of this paragraph (f)(3)(i). However, in all cases, the exemption is not effective until 30 days after notice has been sent.

(C) *Delivery.* The notice described in this paragraph (f)(3)(i) is required to be provided to all participants and beneficiaries. The notice may be furnished by any method of delivery that satisfies the requirements of section 104(b)(1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1024(b)(1)) (e.g., first-class mail). If the notice is provided to the participant at the participant's last known address, then the requirements of this paragraph (f)(3)(i) are satisfied with respect to the participant and all beneficiaries residing at that address. If a beneficiary's last known address is different from the participant's last known address, a separate notice is required to be provided to the beneficiary at the beneficiary's last known address.

(D) *Example.* The rules of this paragraph (f)(3)(i) are illustrated by the following example:

Example. (i) A group health plan has a plan year that is the calendar year and has an open enrollment period every November 1 through November 30. The plan determines on September 15 that it satisfies the requirements of paragraph (f)(2) of this section. As part of its open enrollment materials, the plan mails, on October 15, to all participants and beneficiaries a notice satisfying the requirements of this paragraph (f)(3)(i).

(ii) In this *Example*, the plan has sent the notice in a manner that complies with this paragraph (f)(3)(i).

(ii) *Federal agencies.* A group health plan that is a church plan (as defined in section 414(e)) claiming the exemption of this paragraph (f) for any benefit package must provide notice in accordance with the requirement of this paragraph (f)(3)(ii). This requirement is satisfied if the plan sends a copy, to the address designated by the Secretary in generally applicable guidance, of the notice described in paragraph (f)(3)(i) of this section identifying the benefit package to which the exemption applies. For any other group

health plan, see 29 CFR 2590.712(f)(3)(ii)(B).

(4) *Availability of documentation.* The plan must make available to participants and beneficiaries (or their representatives), on request and at no charge, a summary of the information on which the exemption was based. An individual who is not a participant or beneficiary and who presents a notice described in paragraph (f)(3)(i) of this section is considered to be a representative. A representative may request the summary of information by providing the plan a copy of the notice provided to the participant under paragraph (f)(3)(i) of this section with any individually identifiable information redacted. The summary of information must include the incurred expenditures, the base period, the dollar amount of claims incurred during the base period that would have been denied under the terms of the plan absent amendments required to comply with paragraph (b)(1)(i) of this section, the administrative costs related to those claims, and other administrative costs attributable to complying with the requirements of this section. In no event should the summary of information include any individually identifiable information.

(g) *Special rules for group health insurance coverage*—(1) *Sale of nonparity policies.* See 29 CFR 2590.712(g)(1) and 45 CFR 146.136(g)(1) for rules limiting the right of an issuer to sell a policy without parity (as described in 29 CFR 2590.712(b) and 45 CFR 146.136(b)) to a plan that meets the requirements of 29 CFR 2590.712 (e) or (f) and 45 CFR 146.136 (e) or (f)).

(2) *Duration of exemption.* After a plan meets the requirements of paragraph (f) of this section, the plan may change issuers without having to meet the requirements of paragraph (f) of this section again before September 30, 2001.

(h) *Effective dates*—(1) *In general.* The requirements of this section are applicable for plan years beginning on or after January 1, 1998.

(2) *Limitation on actions.* (i) Except as provided in paragraph (h)(3) of this section, no enforcement action is to be taken by the Secretary against a group health plan that has sought to comply in good faith with the requirements of section 9812, with respect to a violation that occurs before the earlier of—

(A) The first day of the first plan year beginning on or after April 1, 1998; or

(B) January 1, 1999.

(ii) Compliance with the requirements of this section is deemed to be good faith compliance with the requirements of section 9812.

(iii) The rules of this paragraph (h)(2) are illustrated by the following examples:

Example 1. (i) A group health plan has a plan year that is the calendar year. The plan complies with section 9812 in good faith using assumptions inconsistent with paragraph (b)(6) of this section relating to weighted averages for categories of benefits.

(ii) In this *Example 1,* no enforcement action may be taken against the plan with respect to a violation resulting solely from those assumptions and occurring before January 1, 1999.

Example 2. (i) A group health plan has a plan year that is the calendar year. For the entire 1998 plan year, the plan applies a $1,000,000 annual limit on medical/surgical benefits and a $100,000 annual limit on mental health benefits.

(ii) In this *Example 2,* the plan has not sought to comply with the requirements of section 9812 in good faith, and this paragraph (h)(2) does not apply.

(3) *Transition period for increased cost exemption*—(i) *In general.* No enforcement action will be taken against a group health plan that is subject to the requirements of this section based on a violation of this section that occurs before April 1, 1998 solely because the plan claims the increased cost exemption under section 9812(c)(2) based on assumptions inconsistent with the rules under paragraph (f) of this section, provided that a plan amendment that complies with the requirements of paragraph (b)(1)(i) of this section is adopted and effective no later than March 31, 1998 and the plan complies with the notice requirements in paragraph (h)(3)(ii) of this section.

(ii) *Notice of plan's use of transition period.* (A) A group health plan satisfies the requirements of this paragraph (h)(3)(ii) only if the plan provides notice to the applicable federal agency and posts the notice at the location(s) where documents must be made available for examination by participants and beneficiaries under section 104(b)(2)

of the Employee Retirement Income Security Act of 1974, and the regulations thereunder (29 CFR 2520.104b–1(b)(3)). The notice must indicate the plan's decision to use the transition period in paragraph (h)(3)(i) of this section by 30 days after the first day of the plan year beginning on or after January 1, 1998, but in no event later than March 31, 1998. For a group health plan that is a church plan (as defined in section 414(e)), the applicable federal agency is the Department of the Treasury. For a group health plan that is not a church plan, see 29 CFR 2590.712(h)(3)(ii). The notice must include—

(*1*) The name of the plan and the plan number (PN);

(*2*) The name, address, and telephone number of the plan administrator;

(*3*) For single-employer plans, the name, address, and telephone number of the plan sponsor (if different from the plan administrator) and the plan sponsor's employer identification number (EIN);

(*4*) The name and telephone number of the individual to contact for further information; and

(*5*) The signature of the plan administrator and the date of the signature.

(B) The notice must be provided at no charge to participants or their representative within 15 days after receipt of a written or oral request for such notification, but in no event before the notice has been sent to the applicable federal agency.

(i) *Sunset*. This section does not apply to benefits for services furnished on or after September 30, 2001.

[T.D. 8741, 62 FR 66953, Dec. 22, 1997]

EFFECTIVE DATE NOTE: By T.D. 9479, 75 FR 5431, Feb. 2, 2010, § 54.9812–1T was revised, effective Apr. 5, 2010. For the convenience of the user, the revised text is set forth as follows:

§ 54.9812–1T Parity in mental health and substance use disorder benefits (temporary).

(a) *Meaning of terms*. For purposes of this section, except where the context clearly indicates otherwise, the following terms have the meanings indicated:

Aggregate lifetime dollar limit means a dollar limitation on the total amount of specified benefits that may be paid under a group health plan for any coverage unit.

Annual dollar limit means a dollar limitation on the total amount of specified benefits that may be paid in a 12-month period under a group health plan for any coverage unit.

Coverage unit means coverage unit as described in paragraph (c)(1)(iv) of this section.

Cumulative financial requirements are financial requirements that determine whether or to what extent benefits are provided based on accumulated amounts and include deductibles and out-of-pocket maximums. (However, cumulative financial requirements do not include aggregate lifetime or annual dollar limits because these two terms are excluded from the meaning of financial requirements.)

Cumulative quantitative treatment limitations are treatment limitations that determine whether or to what extent benefits are provided based on accumulated amounts, such as annual or lifetime day or visit limits.

Financial requirements include deductibles, copayments, coinsurance, or out-of-pocket maximums. Financial requirements do not include aggregate lifetime or annual dollar limits.

Medical/surgical benefits means benefits for medical or surgical services, as defined under the terms of the plan, but does not include mental health or substance use disorder benefits. Any condition defined by the plan as being or as not being a medical/surgical condition must be defined to be consistent with generally recognized independent standards of current medical practice (for example, the most current version of the International Classification of Diseases (ICD) or State guidelines).

Mental health benefits means benefits with respect to services for mental health conditions, as defined under the terms of the plan and in accordance with applicable Federal and State law. Any condition defined by the plan as being or as not being a mental health condition must be defined to be consistent with generally recognized independent standards of current medical practice (for example, the most current version of the Diagnostic and Statistical Manual of Mental Disorders (DSM), the most current version of the ICD, or State guidelines).

Substance use disorder benefits means benefits with respect to services for substance use disorders, as defined under the terms of the plan and in accordance with applicable Federal and State law. Any disorder defined by the plan as being or as not being a substance use disorder must be defined to be consistent with generally recognized independent standards of current medical practice (for example, the most current version of the DSM, the most current version of the ICD, or State guidelines).

Treatment limitations include limits on benefits based on the frequency of treatment, number of visits, days of coverage, days in a waiting period, or other similar limits on the

scope or duration of treatment. Treatment limitations include both quantitative treatment limitations, which are expressed numerically (such as 50 outpatient visits per year), and nonquantitative treatment limitations, which otherwise limit the scope or duration of benefits for treatment under a plan. (See paragraph (c)(4)(ii) of this section for an illustrative list of nonquantitative treatment limitations.) A permanent exclusion of all benefits for a particular condition or disorder, however, is not a treatment limitation.

(b) *Parity requirements with respect to aggregate lifetime and annual dollar limits*—(1) *General*—(i) *General parity requirement*. A group health plan that provides both medical/surgical benefits and mental health or substance use disorder benefits must comply with paragraph (b)(2), (b)(3), or (b)(6) of this section.

(ii) *Exception*. The rule in paragraph (b)(1)(i) of this section does not apply if a plan satisfies the requirements of paragraph (f) or (g) of this section (relating to exemptions for small employers and for increased cost).

(2) *Plan with no limit or limits on less than one-third of all medical/surgical benefits*. If a plan does not include an aggregate lifetime or annual dollar limit on any medical/surgical benefits or includes an aggregate lifetime or annual dollar limit that applies to less than one-third of all medical/surgical benefits, it may not impose an aggregate lifetime or annual dollar limit, respectively, on mental health or substance use disorder benefits.

(3) *Plan with a limit on at least two-thirds of all medical/surgical benefits*. If a plan includes an aggregate lifetime or annual dollar limit on at least two-thirds of all medical/surgical benefits, it must either—

(i) Apply the aggregate lifetime or annual dollar limit both to the medical/surgical benefits to which the limit would otherwise apply and to mental health or substance use disorder benefits in a manner that does not distinguish between the medical/surgical benefits and mental health or substance use disorder benefits; or

(ii) Not include an aggregate lifetime or annual dollar limit on mental health or substance use disorder benefits that is less than the aggregate lifetime or annual dollar limit, respectively, on medical/surgical benefits. (For cumulative limits other than aggregate lifetime or annual dollar limits, see paragraph (c)(3)(v) of this section prohibiting separately accumulating cumulative financial requirements or cumulative quantitative treatment limitations.)

(4) *Examples*. The rules of paragraphs (b)(2) and (b)(3) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. A group health plan has no annual limit on medical/surgical benefits and a $10,000 annual limit on mental health and substance use disorder benefits. To comply with the requirements of this paragraph (b), the plan sponsor is considering each of the following options:

(A) Eliminating the plan's annual dollar limit on mental health and substance use disorder benefits;

(B) Replacing the plan's annual dollar limit on mental health and substance use disorder benefits with a $500,000 annual limit on all benefits (including medical/surgical and mental health and substance use disorder benefits); and

(C) Replacing the plan's annual dollar limit on mental health and substance use disorder benefits with a $250,000 annual limit on medical/surgical benefits and a $250,000 annual limit on mental health and substance use disorder benefits.

(ii) *Conclusion*. In this *Example 1*, each of the three options being considered by the plan sponsor would comply with the requirements of this paragraph (b).

Example 2. (i) *Facts*. A plan has a $100,000 annual limit on medical/surgical inpatient benefits and a $50,000 annual limit on medical/surgical outpatient benefits. To comply with the parity requirements of this paragraph (b), the plan sponsor is considering each of the following options:

(A) Imposing a $150,000 annual limit on mental health and substance use disorder benefits; and

(B) Imposing a $100,000 annual limit on mental health and substance use disorder inpatient benefits and a $50,000 annual limit on mental health and substance use disorder outpatient benefits.

(ii) *Conclusion*. In this *Example 2*, each option under consideration by the plan sponsor would comply with the requirements of this section.

(5) *Determining one-third and two-thirds of all medical/surgical benefits*. For purposes of this paragraph (b), the determination of whether the portion of medical/surgical benefits subject to an aggregate lifetime or annual dollar limit represents one-third or two-thirds of all medical/surgical benefits is based on the dollar amount of all plan payments for medical/surgical benefits expected to be paid under the plan for the plan year (or for the portion of the plan year after a change in plan benefits that affects the applicability of the aggregate lifetime or annual dollar limits). Any reasonable method may be used to determine whether the dollar amount expected to be paid under the plan will constitute one-third or two-thirds of the dollar amount of all plan payments for medical/surgical benefits.

(6) *Plan not described in paragraph (b)(2) or (b)(3) of this section*—(i) *In general*. A group

health plan that is not described in paragraph (b)(2) or (b)(3) of this section with respect to aggregate lifetime or annual dollar limits on medical/surgical benefits, must either—

(A) Impose no aggregate lifetime or annual dollar limit, as appropriate, on mental health or substance use disorder benefits; or

(B) Impose an aggregate lifetime or annual dollar limit on mental health or substance use disorder benefits that is no less than an average limit calculated for medical/surgical benefits in the following manner. The average limit is calculated by taking into account the weighted average of the aggregate lifetime or annual dollar limits, as appropriate, that are applicable to the categories of medical/surgical benefits. Limits based on delivery systems, such as inpatient/outpatient treatment or normal treatment of common, low-cost conditions (such as treatment of normal births), do not constitute categories for purposes of this paragraph (b)(6)(i)(B). In addition, for purposes of determining weighted averages, any benefits that are not within a category that is subject to a separately-designated dollar limit under the plan are taken into account as a single separate category by using an estimate of the upper limit on the dollar amount that a plan may reasonably be expected to incur with respect to such benefits, taking into account any other applicable restrictions under the plan.

(ii) *Weighting*. For purposes of this paragraph (b)(6), the weighting applicable to any category of medical/surgical benefits is determined in the manner set forth in paragraph (b)(5) of this section for determining one-third or two-thirds of all medical/surgical benefits.

(iii) *Example*. The rules of this paragraph (b)(6) are illustrated by the following example:

Example. (i) *Facts*. A group health plan that is subject to the requirements of this section includes a $100,000 annual limit on medical/surgical benefits related to cardio-pulmonary diseases. The plan does not include an annual dollar limit on any other category of medical/surgical benefits. The plan determines that 40 percent of the dollar amount of plan payments for medical/surgical benefits are related to cardio-pulmonary diseases. The plan determines that $1,000,000 is a reasonable estimate of the upper limit on the dollar amount that the plan may incur with respect to the other 60 percent of payments for medical/surgical benefits.

(ii) *Conclusion*. In this *Example*, the plan is not described in paragraph (b)(3) of this section because there is not one annual dollar limit that applies to at least two-thirds of all medical/surgical benefits. Further, the plan is not described in paragraph (b)(2) of this section because more than one-third of all medical/surgical benefits are subject to an annual dollar limit. Under this paragraph (b)(6), the plan sponsor can choose either to include no annual dollar limit on mental health or substance use disorder benefits, or to include an annual dollar limit on mental health or substance use disorder benefits that is not less than the weighted average of the annual dollar limits applicable to each category of medical/surgical benefits. In this example, the minimum weighted average annual dollar limit that can be applied to mental health or substance use disorder benefits is $640,000 (40% × $100,000 + 60% × $1,000,000 = $640,000).

(c) *Parity requirements with respect to financial requirements and treatment limitations*—(1) *Clarification of terms*—(i) *Classification of benefits*. When reference is made in this paragraph (c) to a classification of benefits, the term ''classification'' means a classification as described in paragraph (c)(2)(ii) of this section.

(ii) *Type of financial requirement or treatment limitation*. When reference is made in this paragraph (c) to a type of financial requirement or treatment limitation, the reference to type means its nature. Different types of financial requirements include deductibles, copayments, coinsurance, and out-of-pocket maximums. Different types of quantitative treatment limitations include annual, episode, and lifetime day and visit limits. See paragraph (c)(4)(ii) of this section for an illustrative list of nonquantitative treatment limitations.

(iii) *Level of a type of financial requirement or treatment limitation*. When reference is made in this paragraph (c) to a level of a type of financial requirement or treatment limitation, level refers to the magnitude of the type of financial requirement or treatment limitation. For example, different levels of coinsurance include 20 percent and 30 percent; different levels of a copayment include $15 and $20; different levels of a deductible include $250 and $500; and different levels of an episode limit include 21 inpatient days per episode and 30 inpatient days per episode.

(iv) *Coverage unit*. When reference is made in this paragraph (c) to a coverage unit, coverage unit refers to the way in which a plan groups individuals for purposes of determining benefits, or premiums or contributions. For example, different coverage units include self-only, family, and employee-plus-spouse.

(2) *General parity requirement*—(i) *General rule*. A group health plan that provides both medical/surgical benefits and mental health or substance use disorder benefits may not

apply any financial requirement or treatment limitation to mental health or substance use disorder benefits in any classification that is more restrictive than the predominant financial requirement or treatment limitation of that type applied to substantially all medical/surgical benefits in the same classification. Whether a financial requirement or treatment limitation is a predominant financial requirement or treatment limitation that applies to substantially all medical/surgical benefits in a classification is determined separately for each type of financial requirement or treatment limitation. The application of the rules of this paragraph (c)(2) to financial requirements and quantitative treatment limitations is addressed in paragraph (c)(3) of this section; the application of the rules of this paragraph (c)(2) to nonquantitative treatment limitations is addressed in paragraph (c)(4) of this section.

(ii) *Classifications of benefits used for applying rules*—(A) *In general.* If a plan provides mental health or substance use disorder benefits in any classification of benefits described in this paragraph (c)(2)(ii), mental health or substance use disorder benefits must be provided in every classification in which medical/surgical benefits are provided. In determining the classification in which a particular benefit belongs, a plan must apply the same standards to medical/surgical benefits and to mental health or substance use disorder benefits. To the extent that a plan provides benefits in a classification and imposes any separate financial requirement or treatment limitation (or separate level of a financial requirement or treatment limitation) for benefits in the classification, the rules of this paragraph (c) apply separately with respect to that classification for all financial requirements or treatment limitations. The following classifications of benefits are the only classifications used in applying the rules of this paragraph (c):

(*1*) *Inpatient, in-network.* Benefits furnished on an inpatient basis and within a network of providers established or recognized under a plan.

(*2*) *Inpatient, out-of-network.* Benefits furnished on an inpatient basis and outside any network of providers established or recognized under a plan. This classification includes inpatient benefits under a plan that has no network of providers.

(*3*) *Outpatient, in-network.* Benefits furnished on an outpatient basis and within a network of providers established or recognized under a plan.

(*4*) *Outpatient, out-of-network.* Benefits furnished on an outpatient basis and outside any network of providers established or recognized under a plan. This classification includes outpatient benefits under a plan that has no network of providers.

(*5*) *Emergency care.* Benefits for emergency care.

(*6*) *Prescription drugs.* Benefits for prescription drugs. See special rules for multi-tiered prescription drug benefits in paragraph (c)(3)(iii) of this section.

(B) *Application to out-of-network providers.* See paragraph (c)(2)(ii)(A) of this section, under which a plan that provides mental health or substance use disorder benefits in any classification of benefits must provide mental health or substance use disorder benefits in every classification in which medical/surgical benefits are provided, including out-of-network classifications.

(C) *Examples.* The rules of this paragraph (c)(2)(ii) are illustrated by the following examples. In each example, the group health plan is subject to the requirements of this section and provides both medical/surgical benefits and mental health and substance use disorder benefits.

Example 1. (i) *Facts.* A group health plan offers inpatient and outpatient benefits and does not contract with a network of providers. The plan imposes a $500 deductible on all benefits. For inpatient medical/surgical benefits, the plan imposes a coinsurance requirement. For outpatient medical/surgical benefits, the plan imposes copayments. The plan imposes no other financial requirements or treatment limitations.

(ii) *Conclusion.* In this *Example 1*, because the plan has no network of providers, all benefits provided are out-of-network. Because inpatient, out-of-network medical/surgical benefits are subject to separate financial requirements from outpatient, out-of-network medical/surgical benefits, the rules of this paragraph (c) apply separately with respect to any financial requirements and treatment limitations, including the deductible, in each classification.

Example 2. (i) *Facts.* A plan imposes a $500 deductible on all benefits. The plan has no network of providers. The plan generally imposes a 20 percent coinsurance requirement with respect to all benefits, without distinguishing among inpatient, outpatient, emergency, or prescription drug benefits. The plan imposes no other financial requirements or treatment limitations.

(ii) *Conclusion.* In this *Example 2*, because the plan does not impose separate financial requirements (or treatment limitations) based on classification, the rules of this paragraph (c) apply with respect to the deductible and the coinsurance across all benefits.

Example 3. (i) *Facts.* Same facts as *Example 2*, except the plan exempts emergency care benefits from the 20 percent coinsurance requirement. The plan imposes no other financial requirements or treatment limitations.

(ii) *Conclusion*. In this *Example 3*, because the plan imposes separate financial requirements based on classifications, the rules of this paragraph (c) apply with respect to the deductible and the coinsurance separately for—

(A) Benefits in the emergency classification; and

(B) All other benefits.

Example 4. (i) *Facts*. Same facts as *Example 2*, except the plan also imposes a preauthorization requirement for all inpatient treatment in order for benefits to be paid. No such requirement applies to outpatient treatment.

(ii) *Conclusion*. In this *Example 4*, because the plan has no network of providers, all benefits provided are out-of-network. Because the plan imposes a separate treatment limitation based on classifications, the rules of this paragraph (c) apply with respect to the deductible and coinsurance separately for—

(A) Inpatient, out-of-network benefits; and

(B) All other benefits.

(3) *Financial requirements and quantitative treatment limitations*—(i) *Determining ''substantially all'' and ''predominant''*—(A) *Substantially all*. For purposes of this paragraph (c), a type of financial requirement or quantitative treatment limitation is considered to apply to substantially all medical/surgical benefits in a classification of benefits if it applies to at least two-thirds of all medical/surgical benefits in that classification. (For this purpose, benefits expressed as subject to a zero level of a type of financial requirement are treated as benefits not subject to that type of financial requirement, and benefits expressed as subject to a quantitative treatment limitation that is unlimited are treated as benefits not subject to that type of quantitative treatment limitation.) If a type of financial requirement or quantitative treatment limitation does not apply to at least two-thirds of all medical/surgical benefits in a classification, then that type cannot be applied to mental health or substance use disorder benefits in that classification.

(B) *Predominant*—(*1*) If a type of financial requirement or quantitative treatment limitation applies to at least two-thirds of all medical/surgical benefits in a classification as determined under paragraph (c)(3)(i)(A) of this section, the level of the financial requirement or quantitative treatment limitation that is considered the predominant level of that type in a classification of benefits is the level that applies to more than one-half of medical/surgical benefits in that classification subject to the financial requirement or quantitative treatment limitation.

(*2*) If, with respect to a type of financial requirement or quantitative treatment limitation that applies to at least two-thirds of all medical/surgical benefits in a classification, there is no single level that applies to more than one-half of medical/surgical benefits in the classification subject to the financial requirement or quantitative treatment limitation, the plan may combine levels until the combination of levels applies to more than one-half of medical/surgical benefits subject to the financial requirement or quantitative treatment limitation in the classification. The least restrictive level within the combination is considered the predominant level of that type in the classification. (For this purpose, a plan may combine the most restrictive levels first, with each less restrictive level added to the combination until the combination applies to more than one-half of the benefits subject to the financial requirement or treatment limitation.)

(C) *Portion based on plan payments*. For purposes of this paragraph (c), the determination of the portion of medical/surgical benefits in a classification of benefits subject to a financial requirement or quantitative treatment limitation (or subject to any level of a financial requirement or quantitative treatment limitation) is based on the dollar amount of all plan payments for medical/surgical benefits in the classification expected to be paid under the plan for the plan year (or for the portion of the plan year after a change in plan benefits that affects the applicability of the financial requirement or quantitative treatment limitation).

(D) *Clarifications for certain threshold requirements*. For any deductible, the dollar amount of plan payments includes all plan payments with respect to claims that would be subject to the deductible if it had not been satisfied. For any out-of-pocket maximum, the dollar amount of plan payments includes all plan payments associated with out-of-pocket payments that are taken into account towards the out-of-pocket maximum as well as all plan payments associated with out-of-pocket payments that would have been made towards the out-of-pocket maximum if it had not been satisfied. Similar rules apply for any other thresholds at which the rate of plan payment changes.

(E) *Determining the dollar amount of plan payments*. Subject to paragraph (c)(3)(i)(D) of this section, any reasonable method may be used to determine the dollar amount expected to be paid under a plan for medical/surgical benefits subject to a financial requirement or quantitative treatment limitation (or subject to any level of a financial requirement or quantitative treatment limitation).

(ii) *Application to different coverage units*. If a plan applies different levels of a financial requirement or quantitative treatment limitation to different coverage units in a classification of medical/surgical benefits, the predominant level that applies to substantially

all medical/surgical benefits in the classification is determined separately for each coverage unit.

(iii) *Special rule for multi-tiered prescription drug benefits.* If a plan applies different levels of financial requirements to different tiers of prescription drug benefits based on reasonable factors determined in accordance with the rules in paragraph (c)(4)(i) of this section (relating to requirements for nonquantitative treatment limitations) and without regard to whether a drug is generally prescribed with respect to medical/surgical benefits or with respect to mental health or substance use disorder benefits, the plan satisfies the parity requirements of this paragraph (c) with respect to prescription drug benefits. Reasonable factors include cost, efficacy, generic versus brand name, and mail order versus pharmacy pick-up.

(iv) *Examples.* The rules of paragraphs (c)(3)(i), (c)(3)(ii), and (c)(3)(iii) of this section are illustrated by the following examples. In each example, the group health plan is subject to the requirements of this section and provides both medical/surgical benefits and mental health and substance use disorder benefits.

Example 1. (i) *Facts.* For inpatient, out-of-network medical/surgical benefits, a group health plan imposes five levels of coinsurance. Using a reasonable method, the plan projects its payments for the upcoming year as follows:

Coinsurance rate.	0%	10%	15%	20%	30%	Total
Projected payments.	$200x	$100x	$450x	$100x	$150x	$1,000x
Percent of total plan costs.	20%	10%	45%	10%	15%	
Percent subject to coinsurance level.	N/A	12.5% (100x/800x)	56.25% (450x/800x)	12.5% (100x/800x)	18.75% (150x/800x)	

The plan projects plan costs of $800x to be subject to coinsurance ($100x + $450x + $100x + $150x = $800x). Thus, 80 percent ($800x/$1,000x) of the benefits are projected to be subject to coinsurance, and 56.25 percent of the benefits subject to coinsurance are projected to be subject to the 15 percent coinsurance level.

(ii) *Conclusion.* In this *Example 1,* the two-thirds threshold of the substantially all standard is met for coinsurance because 80 percent of all inpatient, out-of-network medical/surgical benefits are subject to coinsurance. Moreover, the 15 percent coinsurance is the predominant level because it is applicable to more than one-half of inpatient, out-of-network medical/surgical benefits subject to the coinsurance requirement. The plan may not impose any level of coinsurance with respect to inpatient, out-of-network mental health or substance use disorder benefits that is more restrictive than the 15 percent level of coinsurance.

Example 2. (i) *Facts.* For outpatient, in-network medical/surgical benefits, a plan imposes five different copayment levels. Using a reasonable method, the plan projects payments for the upcoming year as follows:

Copayment amount.	$0	$10	$15	$20	$50	Total

Projected payments.	$200x	$200x	$200x	$300x	$100x	$1,000x
Percent of total plan costs.	20%	20%	20%	30%	10%	
Percent subject to copayments.	N/A	25% (200x/800x)	25% (200x/800x)	37.5% (300x/800x)	12.5% (100x/800x)	

The plan projects plan costs of $800x to be subject to copayments ($200x + $200x + $300x + $100x = $800x). Thus, 80 percent ($800x/$1,000x) of the benefits are projected to be subject to a copayment.

(ii) *Conclusion*. In this *Example 2*, the two-thirds threshold of the substantially all standard is met for copayments because 80 percent of all outpatient, in-network medical/surgical benefits are subject to a copayment. Moreover, there is no single level that applies to more than one-half of medical/surgical benefits in the classification subject to a copayment (for the $10 copayment, 25 percent; for the $15 copayment, 25 percent; for the $20 copayment, 37.5 percent; and for the $50 copayment, 12.5 percent). The plan can combine any levels of copayment, including the highest levels, to determine the predominant level that can be applied to mental health or substance use disorder benefits. If the plan combines the highest levels of copayment, the combined projected payments for the two highest copayment levels, the $50 copayment and the $20 copayment, are not more than one-half of the outpatient, in-network medical/surgical benefits subject to a copayment because they are exactly one-half ($300x + $100x = $400x; $400x/$800x = 50%). The combined projected payments for the three highest copayment levels—the $50 copayment, the $20 copayment, and the $15 copayment—are more than one-half of the outpatient, in-network medical/surgical benefits subject to the copayments ($100x + $300x + $200x = $600x; $600x/$800x = 75%). Thus, the plan may not impose any copayment on outpatient, in-network mental health or substance use disorder benefits that is more restrictive than the least restrictive copayment in the combination, the $15 copayment.

Example 3. (i) *Facts*. A plan imposes a $250 deductible on all medical/surgical benefits for self-only coverage and a $500 deductible on all medical/surgical benefits for family coverage. The plan has no network of providers. For all medical/surgical benefits, the plan imposes a coinsurance requirement. The plan imposes no other financial requirements or treatment limitations.

(ii) *Conclusion*. In this *Example 3*, because the plan has no network of providers, all benefits are provided out-of-network. Because self-only and family coverage are subject to different deductibles, whether the deductible applies to substantially all medical/surgical benefits is determined separately for self-only medical/surgical benefits and family medical/surgical benefits. Because the coinsurance is applied without regard to coverage units, the predominant coinsurance that applies to substantially all medical/surgical benefits is determined without regard to coverage units.

Example 4. (i) *Facts*. A plan applies the following financial requirements for prescription drug benefits. The requirements are applied without regard to whether a drug is generally prescribed with respect to medical/surgical benefits or with respect to mental health or substance use disorder benefits. Moreover, the process for certifying a particular drug as ''generic'', ''preferred brand name'', ''non-preferred brand name'', or ''specialty'' complies with the rules of paragraph (c)(4)(i) of this section (relating to requirements for nonquantitative treatment limitations).

Tier description	Tier 1	Tier 2	Tier 3	Tier 4
	Generic drugs	Preferred brand name drugs	Non-preferred brand name drugs (which may have Tier 1 or Tier 2 alternatives)	Specialty drugs
Percent paid by plan	90%	80%	60%	50%

(ii) *Conclusion*. In this *Example 4*, the financial requirements that apply to prescription drug benefits are applied without regard to whether a drug is generally prescribed with respect to medical/surgical benefits or with respect to mental health or substance use disorder benefits; the process for certifying drugs in different tiers complies with paragraph (c)(4) of this section; and the bases for establishing different levels or types of financial requirements are reasonable. The financial requirements applied to prescription drug benefits do not violate the parity requirements of this paragraph (c)(3).

(v) *No separate cumulative financial requirements or cumulative quantitative treatment limitations*. (A) A group health plan may not apply any cumulative financial requirement or cumulative quantitative treatment limitation for mental health or substance use disorder benefits in a classification that accumulates separately from any established for medical/surgical benefits in the same classification.

(B) The rules of this paragraph (c)(3)(v) are illustrated by the following examples:

Example 1. (i) *Facts*. A group health plan imposes a combined annual $500 deductible on all medical/surgical, mental health, and substance use disorder benefits.

(ii) *Conclusion*. In this *Example 1*, the combined annual deductible complies with the requirements of this paragraph (c)(3)(v).

Example 2. (i) *Facts*. A plan imposes an annual $250 deductible on all medical/surgical benefits and a separate annual $250 deductible on all mental health and substance use disorder benefits.

(ii) *Conclusion*. In this *Example 2*, the separate annual deductible on mental health and substance use disorder benefits violates the requirements of this paragraph (c)(3)(v).

Example 3. (i) *Facts*. A plan imposes an annual $300 deductible on all medical/surgical benefits and a separate annual $100 deductible on all mental health or substance use disorder benefits.

(ii) *Conclusion*. In this *Example 3*, the separate annual deductible on mental health and substance use disorder benefits violates the requirements of this paragraph (c)(3)(v).

Example 4. (i) *Facts*. A plan generally imposes a combined annual $500 deductible on all benefits (both medical/surgical benefits and mental health and substance use disorder benefits) except prescription drugs. Certain benefits, such as preventive care, are provided without regard to the deductible. The imposition of other types of financial requirements or treatment limitations varies with each classification. Using reasonable methods, the plan projects its payments for medical/surgical benefits in each classification for the upcoming year as follows:

Classification	Benefits subject to deductible	Total benefits	Percent subject to deductible
Inpatient, in-network	$1,800x	$2,000x	90
Inpatient, out-of-network	1,000x	1,000x	100
Outpatient, in-network	1,400x	2,000x	70
Outpatient, out-of-network	1,880x	2,000x	94
Emergency care	300x	500x	60

(ii) *Conclusion*. In this *Example 4*, the two-thirds threshold of the substantially all standard is met with respect to each classification except emergency care because in each of those other classifications at least two-thirds of medical/surgical benefits are subject to the $500 deductible. Moreover, the $500 deductible is the predominant level in each of those other classifications because it is the only level. However, emergency care mental health and substance use disorder benefits cannot be subject to the $500 deductible because it does not apply to substantially all emergency care medical/surgical benefits.

(4) *Nonquantitative treatment limitations*—(i) *General rule*. A group health plan may not impose a nonquantitative treatment limitation with respect to mental health or substance use disorder benefits in any classification unless, under the terms of the plan as written and in operation, any processes,

strategies, evidentiary standards, or other factors used in applying the nonquantitative treatment limitation to mental health or substance use disorder benefits in the classification are comparable to, and are applied no more stringently than, the processes, strategies, evidentiary standards, or other factors used in applying the limitation with respect to medical surgical/benefits in the classification, except to the extent that recognized clinically appropriate standards of care may permit a difference.

(ii) *Illustrative list of nonquantitative treatment limitations.* Nonquantitative treatment limitations include—

(A) Medical management standards limiting or excluding benefits based on medical necessity or medical appropriateness, or based on whether the treatment is experimental or investigative;

(B) Formulary design for prescription drugs;

(C) Standards for provider admission to participate in a network, including reimbursement rates;

(D) Plan methods for determining usual, customary, and reasonable charges;

(E) Refusal to pay for higher-cost therapies until it can be shown that a lower-cost therapy is not effective (also known as fail-first policies or step therapy protocols); and

(F) Exclusions based on failure to complete a course of treatment.

(iii) *Examples.* The rules of this paragraph (c)(4) are illustrated by the following examples. In each example, the group health plan is subject to the requirements of this section and provides both medical/surgical benefits and mental health and substance use disorder benefits.

Example 1. (i) *Facts.* A group health plan limits benefits to treatment that is medically necessary. The plan requires concurrent review for inpatient, in-network mental health and substance use disorder benefits but does not require it for any inpatient, in-network medical/surgical benefits. The plan conducts retrospective review for inpatient, in-network medical/surgical benefits.

(ii) *Conclusion.* In this *Example 1,* the plan violates the rules of this paragraph (c)(4). Although the same nonquantitative treatment limitation—medical necessity—applies to both mental health and substance use disorder benefits and to medical/surgical benefits for inpatient, in-network services, the concurrent review process does not apply to medical/surgical benefits. The concurrent review process is not comparable to the retrospective review process. While such a difference might be permissible in certain individual cases based on recognized clinically appropriate standards of care, it is not permissible for distinguishing between all medical/surgical benefits and all mental health or substance use disorder benefits.

Example 2. (i) *Facts.* A plan requires prior approval that a course of treatment is medically necessary for outpatient, in-network medical/surgical, mental health, and substance use disorder benefits. For mental health and substance use disorder treatments that do not have prior approval, no benefits will be paid; for medical/surgical treatments that do not have prior approval, there will only be a 25 percent reduction in the benefits the plan would otherwise pay.

(ii) *Conclusion.* In this *Example 2,* the plan violates the rules of this paragraph (c)(4). Although the same nonquantitative treatment limitation—medical necessity—is applied both to mental health and substance use disorder benefits and to medical/surgical benefits for outpatient, in-network services, the penalty for failure to obtain prior approval for mental health and substance use disorder benefits is not comparable to the penalty for failure to obtain prior approval for medical/surgical benefits.

Example 3. (i) *Facts.* A plan generally covers medically appropriate treatments. For both medical/surgical benefits and mental health and substance use disorder benefits, evidentiary standards used in determining whether a treatment is medically appropriate (such as the number of visits or days of coverage) are based on recommendations made by panels of experts with appropriate training and experience in the fields of medicine involved. The evidentiary standards are applied in a manner that may differ based on clinically appropriate standards of care for a condition.

(ii) *Conclusion.* In this *Example 3,* the plan complies with the rules of this paragraph (c)(4) because the nonquantitative treatment limitation—medical appropriateness—is the same for both medical/surgical benefits and mental health and substance use disorder benefits, and the processes for developing the evidentiary standards and the application of them to mental health and substance use disorder benefits are comparable to and are applied no more stringently than for medical/surgical benefits. This is the result even if, based on clinically appropriate standards of care, the application of the evidentiary standards does not result in similar numbers of visits, days of coverage, or other benefits utilized for mental health conditions or substance use disorders as it does for any particular medical/surgical condition.

Example 4. (i) *Facts.* A plan generally covers medically appropriate treatments. In determining whether prescription drugs are medically appropriate, the plan automatically excludes coverage for antidepressant drugs that are given a black box warning label by the Food and Drug Administration (indicating the drug carries a significant risk of serious adverse effects). For other drugs with a black box warning (including those prescribed for other mental health conditions

and substance use disorders, as well as for medical/surgical conditions), the plan will provide coverage if the prescribing physician obtains authorization from the plan that the drug is medically appropriate for the individual, based on clinically appropriate standards of care.

(ii) *Conclusion*. In this *Example 4*, the plan violates the rules of this paragraph (c)(4). Although the same nonquantitative treatment limitation—medical appropriateness—is applied to both mental health and substance use disorder benefits and medical/surgical benefits, the plan's unconditional exclusion of antidepressant drugs given a black box warning is not comparable to the conditional exclusion for other drugs with a black box warning.

Example 5. (i) *Facts*. An employer maintains both a major medical program and an employee assistance program (EAP). The EAP provides, among other benefits, a limited number of mental health or substance use disorder counseling sessions. Participants are eligible for mental health or substance use disorder benefits under the major medical program only after exhausting the counseling sessions provided by the EAP. No similar exhaustion requirement applies with respect to medical/surgical benefits provided under the major medical program.

(ii) *Conclusion*. In this *Example 5*, limiting eligibility for mental health and substance use disorder benefits only after EAP benefits are exhausted is a nonquantitative treatment limitation subject to the parity requirements of this paragraph (c). Because no comparable requirement applies to medical/surgical benefits, the requirement may not be applied to mental health or substance use disorder benefits.

(5) *Exemptions*. The rules of this paragraph (c) do not apply if a group health plan satisfies the requirements of paragraph (f) or (g) of this section (relating to exemptions for small employers and for increased cost).

(d) *Availability of plan information*—(1) *Criteria for medical necessity determinations*. The criteria for medical necessity determinations made under a group health plan with respect to mental health or substance use disorder benefits must be made available by the plan administrator to any current or potential participant, beneficiary, or contracting provider upon request.

(2) *Reason for denial*. The reason for any denial under a group health plan of reimbursement or payment for services with respect to mental health or substance use disorder benefits in the case of any participant or beneficiary must be made available by the plan administrator to the participant or beneficiary in accordance with this paragraph (d)(2).

(i) *Plans subject to ERISA*. If a plan is subject to ERISA, it must provide the reason for the claim denial in a form and manner consistent with the requirements of 29 CFR 2560.503–1 for group health plans.

(ii) *Plans not subject to ERISA*. If a plan is not subject to ERISA, upon the request of a participant or beneficiary the reason for the claim denial must be provided within a reasonable time and in a reasonable manner. For this purpose, a plan that follows the requirements of 29 CFR 2560.503–1 for group health plans complies with the requirements of this paragraph (d)(2)(ii).

(e) *Applicability*—(1) *Group health plans*. The requirements of this section apply to a group health plan offering medical/surgical benefits and mental health or substance use disorder benefits. If, under an arrangement or arrangements to provide health care benefits by an employer or employee organization (including for this purpose a joint board of trustees of a multiemployer trust affiliated with one or more multiemployer plans), any participant (or beneficiary) can simultaneously receive coverage for medical/surgical benefits and coverage for mental health or substance use disorder benefits, then the requirements of this section (including the exemption provisions in paragraph (g) of this section) apply separately with respect to each combination of medical/surgical benefits and of mental health or substance use disorder benefits that any participant (or beneficiary) can simultaneously receive from that employer's or employee organization's arrangement or arrangements to provide health care benefits, and all such combinations are considered for purposes of this section to be a single group health plan.

(2) *Health insurance issuers*. See 29 CFR 2590.712(e)(2) and 45 CFR 146.136(e)(2), under which a health insurance issuer offering health insurance coverage for mental health or substance use disorder benefits is subject to requirements similar to those applicable to group health plans under this section if the health insurance coverage is offered in connection with a group health plan subject to requirements under 29 CFR 2590.712 or 45 CFR 146.136 similar to those applicable to group health plans under this section.

(3) *Scope*. This section does not—

(i) Require a group health plan to provide any mental health benefits or substance use disorder benefits, and the provision of benefits by a plan for one or more mental health conditions or substance use disorders does not require the plan under this section to provide benefits for any other mental health condition or substance use disorder; or

(ii) Affect the terms and conditions relating to the amount, duration, or scope of mental health or substance use disorder benefits under the plan except as specifically provided in paragraphs (b) and (c) of this section.

(f) *Small employer exemption*—(1) *In general*. The requirements of this section do not

apply to a group health plan for a plan year of a small employer. For purposes of this paragraph (f), the term *small employer* means, in connection with a group health plan with respect to a calendar year and a plan year, an employer who employed an average of at least two (or one in the case of an employer residing in a state that permits small groups to include a single individual) but not more than 50 employees on business days during the preceding calendar year. See section 9831(a)(2) and § 54.9831–1(b), which provide that this section (and certain other sections) does not apply to any group health plan for any plan year if, on the first day of the plan year, the plan has fewer than two participants who are current employees.

(2) *Rules in determining employer size.* For purposes of paragraph (f)(1) of this section—

(i) All persons treated as a single employer under subsections (b), (c), (m), and (o) of section 414 are treated as one employer;

(ii) If an employer was not in existence throughout the preceding calendar year, whether it is a small employer is determined based on the average number of employees the employer reasonably expects to employ on business days during the current calendar year; and

(iii) Any reference to an employer for purposes of the small employer exemption includes a reference to a predecessor of the employer.

(g) *Increased cost exemption* [Reserved]

(h) *Sale of nonparity health insurance coverage.* See 29 CFR 2590.712(h) and 45 CFR 146.136(h), under which a health insurance issuer may not sell a policy, certificate, or contract of insurance that fails to comply with requirements similar to those under paragraph (b) or (c) of this section, except to a plan for a year for which the plan is exempt from requirements similar to those under paragraph (b) or (c) of this section because the plan meets requirements under paragraph (f) or (g) of 29 CFR 2590.712 or 45 CFR 146.136 similar to those under paragraph (f) or (g) of this section.

(i) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraph (i)(2) of this section, the requirements of this section are applicable for plan years beginning on or after July 1, 2010.

(2) *Special effective date for certain collectively-bargained plans.* For a group health plan maintained pursuant to one or more collective bargaining agreements ratified before October 3, 2008, the requirements of this section do not apply to the plan for plan years beginning before the later of either—

(i) The date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension agreed to after October 3, 2008); or

(ii) July 1, 2010.

(j) *Expiration date.* This section expires on or before *January 29, 2013.*

§ 54.9831–1 Special rules relating to group health plans.

(a) *Group health plan*—(1) *Defined.* A group health plan means a plan (including a self-insured plan) of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families.

(2) *Determination of number of plans.* [Reserved]

(b) *General exception for certain small group health plans.* (1) Subject to paragraph (b)(2) of this section, the requirements of §§ 54.9801–1 through 54.9801–6, 54.9802–1, 54.9802–2, 54.9811–1, 54.9812–1T, and 54.9833–1 do not apply to any group health plan for any plan year if, on the first day of the plan year, the plan has fewer than two participants who are current employees.

(2) The exception of paragraph (b)(1) of this section does not apply with respect to the following requirements:

(i) Section 54.9801–3(b)(6).

(ii) Section 54.9802–1(b), as such paragraph applies with respect to genetic information as a health factor.

(iii) Section 54.9802–1(c), as such paragraph applies with respect to genetic information as a health factor.

(iv) Section 54.9802–1(e), as such paragraph applies with respect to genetic information as a health factor.

(v) Section 54.9802–3T(b).

(vi) Section 54.9802–3T(c).

(vii) Section 54.9802–3T(d).

(viii) Section 54.9802–3T(e).

(c) *Excepted benefits*—(1) *In general.* The requirements of §§ 54.9801–1 through 54.9801–6, 54.9802–1, 54.9802–2, 54.9811–1T, 54.9812–1T, and 54.9833–1 do not apply to any group health plan in relation to its provision of the benefits described in paragraph (c)(2), (3), (4), or (5) of this section (or any combination of these benefits).

(2) *Benefits excepted in all circumstances.* The following benefits are excepted in all circumstances—

(i) Coverage only for accident (including accidental death and dismemberment);

(ii) Disability income coverage;

(iii) Liability insurance, including general liability insurance and automobile liability insurance;

(iv) Coverage issued as a supplement to liability insurance;

(v) Workers' compensation or similar coverage;

(vi) Automobile medical payment insurance;

(vii) Credit-only insurance (for example, mortgage insurance); and

(viii) Coverage for on-site medical clinics.

(3) *Limited excepted benefits*—(i) *In general*. Limited-scope dental benefits, limited-scope vision benefits, or long-term care benefits are excepted if they are provided under a separate policy, certificate, or contract of insurance, or are otherwise not an integral part of a group health plan as described in paragraph (c)(3)(ii) of this section. In addition, benefits provided under a health flexible spending arrangement are excepted benefits if they satisfy the requirements of paragraph (c)(3)(v) of this section.

(ii) *Not an integral part of a group health plan*. For purposes of this paragraph (c)(3), benefits are not an integral part of a group health plan (whether the benefits are provided through the same plan or a separate plan) only if the following two requirements are satisfied—

(A) Participants must have the right to elect not to receive coverage for the benefits; and

(B) If a participant elects to receive coverage for the benefits, the participant must pay an additional premium or contribution for that coverage.

(iii) *Limited scope*—(A) *Dental benefits*. Limited scope dental benefits are benefits substantially all of which are for treatment of the mouth (including any organ or structure within the mouth).

(B) *Vision benefits*. Limited scope vision benefits are benefits substantially all of which are for treatment of the eye.

(iv) *Long-term care*. Long-term care benefits are benefits that are either—

(A) Subject to State long-term care insurance laws;

(B) For qualified long-term care services, as defined in section 7702B(c)(1), or provided under a qualified long-term care insurance contract, as defined in section 7702B(b); or

(C) Based on cognitive impairment or a loss of functional capacity that is expected to be chronic.

(v) *Health flexible spending arrangements*. Benefits provided under a health flexible spending arrangement (as defined in section 106(c)(2)) are excepted for a class of participants only if they satisfy the following two requirements—

(A) Other group health plan coverage, not limited to excepted benefits, is made available for the year to the class of participants by reason of their employment; and

(B) The arrangement is structured so that the maximum benefit payable to any participant in the class for a year cannot exceed two times the participant's salary reduction election under the arrangement for the year (or, if greater, cannot exceed $500 plus the amount of the participant's salary reduction election). For this purpose, any amount that an employee can elect to receive as taxable income but elects to apply to the health flexible spending arrangement is considered a salary reduction election (regardless of whether the amount is characterized as salary or as a credit under the arrangement).

(4) *Noncoordinated benefits*—(i) *Excepted benefits that are not coordinated*. Coverage for only a specified disease or illness (for example, cancer-only policies) or hospital indemnity or other fixed indemnity insurance is excepted only if it meets each of the conditions specified in paragraph (c)(4)(ii) of this section. To be hospital indemnity or other fixed indemnity insurance, the insurance must pay a fixed dollar amount per day (or per other period) of hospitalization or illness (for example, $100/day) regardless of the amount of expenses incurred.

(ii) *Conditions*. Benefits are described in paragraph (c)(4)(i) of this section only if—

(A) The benefits are provided under a separate policy, certificate, or contract of insurance;

(B) There is no coordination between the provision of the benefits and an exclusion of benefits under any group health plan maintained by the same plan sponsor; and

(C) The benefits are paid with respect to an event without regard to whether benefits are provided with respect to the event under any group health plan maintained by the same plan sponsor.

(iii) *Example*. The rules of this paragraph (c)(4) are illustrated by the following example:

Example. (i) *Facts*. An employer sponsors a group health plan that provides coverage through an insurance policy. The policy provides benefits only for hospital stays at a fixed percentage of hospital expenses up to a maximum of $100 a day.

(ii) *Conclusion*. In this *Example*, even though the benefits under the policy satisfy the conditions in paragraph (c)(4)(ii) of this section, because the policy pays a percentage of expenses incurred rather than a fixed dollar amount, the benefits under the policy are not excepted benefits under this paragraph (c)(4). This is the result even if, in practice, the policy pays the maximum of $100 for every day of hospitalization.

(5) *Supplemental benefits*. (i) The following benefits are excepted only if they are provided under a separate policy, certificate, or contract of insurance—

(A) Medicare supplemental health insurance (as defined under section 1882(g)(1) of the Social Security Act; also known as Medigap or MedSupp insurance);

(B) Coverage supplemental to the coverage provided under Chapter 55, Title 10 of the United States Code (also known as TRICARE supplemental programs); and

(C) Similar supplemental coverage provided to coverage under a group health plan. To be similar supplemental coverage, the coverage must be specifically designed to fill gaps in primary coverage, such as coinsurance or deductibles. Similar supplemental coverage does not include coverage that becomes secondary or supplemental only under a coordination-of-benefits provision.

(ii) The rules of this paragraph (c)(5) are illustrated by the following example:

Example. (i) *Facts*. An employer sponsors a group health plan that provides coverage for both active employees and retirees. The coverage for retirees supplements benefits provided by Medicare, but does not meet the requirements for a supplemental policy under section 1882(g)(1) of the Social Security Act.

(ii) *Conclusion*. In this *Example*, the coverage provided to retirees does not meet the definition of supplemental excepted benefits under this paragraph (c)(5) because the coverage is not Medicare supplemental insurance as defined under section 1882(g)(1) of the Social Security Act, is not a TRICARE supplemental program, and is not supplemental to coverage provided under a group health plan.

(d) *Treatment of partnerships*. For purposes of this part:

(1) *Treatment as a group health plan*. (*See* 29 CFR 2590.732(d)(1) and 45 CFR 146.145(d)(1), under which a plan providing medical care, maintained by a partnership, and usually not treated as an employee welfare benefit plan under ERISA is treated as a group health plan for purposes of Part 7 of Subtitle B of Title I of ERISA and Title XXVII of the PHS Act.)

(2) *Employment relationship*. In the case of a group health plan, the term *employer* also includes the partnership in relation to any bona fide partner. In addition, the term *employee* also includes any bona fide partner. Whether or not an individual is a bona fide partner is determined based on all the relevant facts and circumstances, including whether the individual performs services on behalf of the partnership.

(3) *Participants of group health plans*. In the case of a group health plan, the term *participant* also includes any individual described in paragraph (d)(3)(i) or (ii) of this section if the individual is, or may become, eligible to receive a benefit under the plan or the individual's beneficiaries may be eligible to receive any such benefit.

(i) In connection with a group health plan maintained by a partnership, the individual is a partner in relation to the partnership.

(ii) In connection with a group health plan maintained by a self-employed individual (under which one or more employees are participants), the individual is the self-employed individual.

(e) *Determining the average number of employees*. [Reserved]

[T.D. 9166, 69 FR 78746, Dec. 30, 2004; 70 FR 21146, Apr. 25, 2005, as amended by T.D. 9299, 71 FR 75057, Dec. 13, 2006; T.D. 9427, 73 FR 62422, Oct. 20, 2008; T.D. 9464, 74 FR 51678, Oct. 7, 2009]

§ 54.9833–1 Effective dates.

Sections 54.9801–1 through 54.9801–6, 54.9831–1, and this section are applicable for plan years beginning on or after July 1, 2005.

[T.D. 9166, 69 FR 78746, Dec. 30, 2004]

PART 55—EXCISE TAX ON REAL ESTATE INVESTMENT TRUSTS AND REGULATED INVESTMENT COMPANIES

Subpart A—Excise Tax on Real Estate Investment Trusts

Sec.
55.4981–1 Imposition of excise tax on certain real estate investment trust taxable income not distributed during the taxable year; taxable years ending on or before January 1, 1987.
55.4981–2 Imposition of excise tax with respect to certain undistributed income of real estate investment trusts; calendar years beginning after December 31, 1986.

Subpart B—Excise Tax on Regulated Investment Companies

55.4982–1 Imposition of excise tax on undistributed income of regulated investment companies.

Subpart C—Procedure and Administration

55.6001–1 Notice or regulations requiring records, statements, and special returns.
55.6011–1 General requirement of return, statement, or list.
55.6060–1 Reporting requirements for tax return preparers.
55.6061–1 Signing of returns and other documents.
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55.6071–1 Time for filing returns.
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55.6091–2 Exceptional cases.
55.6107–1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.
55.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund.
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55.6165–1 Bonds where time to pay tax or deficiency has been extended.
55.6694–1 Section 6694 penalties applicable to tax return preparer.
55.6694–2 Penalties for understatement due to an unreasonable position.
55.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.
55.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.
55.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.
55.6696–1 Claims for credit or refund by tax return preparers.
55.7701–1 Tax return preparer.

AUTHORITY: 26 U.S.C. 6001, 6011, 6071, 6091, and 7805.

Section 55.4981–1 also issued under sec. 860(e), 92 Stat. 2849 (26 U.S.C. 860(e); sec. 860(g), 92 Stat. 2850 (26 U.S.C. 860(g)); and sec 7805. 68A Stat. 917 (26 U.S.C. 7805) of the Internal Revenue Code of 1954), 26 U.S.C. 7805;

Section 55.6011–1 also issued under 26 U.S.C. 6011(a);

Section 55.6060–1 also issued under 26 U.S.C. 6060(a);

Section 55.6071–1 also issued under 26 U.S.C. 6071(a);

Section 55.6081–1 also issued under 26 U.S.C. 6081(a);

Section 55.6091–1 also issued under 26 U.S.C. 6091(a);

Section 55.6109–1 also issued under 26 U.S.C. 6109(a);

Section 55.6109–2 also issued under 26 U.S.C. 6109(a);

Section 55.6151–1 also issued under 26 U.S.C. 6151;

Section 55.6695–1 also issued under 26 U.S.C. 6695(b).

SOURCE: T.D. 7767, 46 FR 11282, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981, unless otherwise noted.

Subpart A—Excise Tax on Real Estate Investment Trusts

§ 55.4981–1 Imposition of excise tax on certain real estate investment trust taxable income not distributed during the taxable year; taxable years ending on or before January 1, 1987.

Section 4981 as in effect before amendment by the Tax Reform Act of 1986 imposes an excise tax on a real estate investment trust if the deduction for dividends paid for the taxable year does not equal at least 75 percent of its real estate investment trust taxable income (computed as provided in section 4981 as in effect before amendment by

the Tax Reform Act of 1986) for the taxable year. For purposes of section 4981 as in effect before amendment by the Tax Reform Act of 1986, the deduction for dividends paid is computed without regard to capital gains dividends (as defined in section 857(b)(3)(C)) and without regard to any dividends actually paid after the close of the taxable year. Thus, dividends considered as paid during the taxable year under section 858 are disregarded. Deficiency dividends (as defined in section 860(f) paid with respect to the taxable year are also disregarded. The return referred to in the last sentence of section 4981 as in effect before amendment by the Tax Reform Act of 1986 in the income tax return. Section 4981 as in effect before amendment by the Tax Reform Act of 1986, applies only to taxable years beginning after December 31, 1979 and ending before January 1, 1987, for which the taxpayer is taxable under Part II of Subchapter M of Chapter 1 of subtitle A as a real estate investment trust.

[T.D. 7767, 46 FR 11282, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981; T.D. 7936, 49 FR 2109, Jan. 18, 1984; T.D. 8180, 53 FR 6147, Mar. 1, 1988]

§ 55.4981–2 Imposition of excise tax with respect to certain undistributed income of real estate investment trusts; calendar years beginning after December 31, 1986.

Section 4981, as amended by the Tax Reform Act of 1986, imposes an excise tax on a real estate investment trust in the amount of four percent of the excess, if any, of the required distribution for a calendar year over the distributed amount for such calendar year. Section 4981, as so amended, applies only to calendar years that begin after December 31, 1986. For provisions relating to the imposition of an excise tax with respect to certain undistributed income of real estate investment trusts for taxable years ending before January 1, 1987, see § 55.4981–1.

[T.D. 8180, 53 FR 6148, Mar. 1, 1988]

Subpart B—Excise Tax on Regulated Investment Companies

§ 55.4982–1 Imposition of excise tax on undistributed income of regulated investment companies.

Section 4982 imposes an excise tax on a regulated investment company in the amount of four percent of the excess, if any, of the required distribution for a calendar year over the distributed amount for such calendar year. Section 4982 applies only to calendar years beginning after December 31, 1986.

[T.D. 8180, 53 FR 6148, Mar. 1, 1988]

Subpart C—Procedure and Administration

SOURCE: T.D. 7767, 46 FR 11282, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981, unless otherwise noted. Redesignated by T.D. 8180, 53 FR 6148, Mar. 1, 1988.

§ 55.6001–1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* Any person subject to tax under Chapter 44 of the Code shall keep such complete and detailed records as are sufficient to enable the district director to determine accurately the amount of liability under Chapter 44.

(b) *Notice by district director requiring returns, statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under Chapter 44.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§ 55.6011–1 General requirement of return, statement, or list.

Every person liable for tax under Chapter 44 shall file an annual return with respect to the tax on the form

prescribed by the Internal Revenue Service for such purpose and shall include therein the information required by the form and the instructions issued with respect thereto. For calendar years beginning after December 31, 1986, the return, which must be made on a calendar year basis, shall be filed by a real estate investment trust on Form 8612 and by a regulated investment company on Form 8613.

[T.D. 8180, 53 FR 6148, Mar. 1, 1988]

§ 55.6060–1 Reporting requirements for tax return preparers.

(a) *In general.* A person that employs one or more tax return preparers to prepare a return or claim for refund under chapter 44 of subtitle D of the Internal Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 55.6061–1 Signing of returns and other documents.

Any return required to be made by a real estate investment trust or a regulated investment company with respect to the tax imposed by Chapter 44 shall be signed by a person authorized by section 6062 of the Code to sign the income tax return of the real estate investment trust or the regulated investment company. Any statement or other document required to be made with respect to the tax imposed by Chapter 44 shall be signed by the person required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such statement or document. An individual's signature on a return, statement, or other document made by or for the real estate investment trust or the regulated investment company shall be prima facie evidence that the individual is authorized to sign the return, statement, or other document.

[T.D. 8180, 53 FR 6148, Mar. 1, 1988]

§ 55.6065–1 Verification of returns.

If a return, statement, or other document made under the provisions of Chapter 44 or Subtitle F or the Code or the regulations thereunder with respect to any tax imposed by Chapter 44 of the Code, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of Chapter 44 or Subtitle F of the Code or regulations thereunder with respect to any tax imposed by Chapter 44 of the Code may be required to contain or be verified by a written declaration that it is made under the penalties of perjury.

§ 55.6071–1 Time for filing returns.

(a) *Returns for calendar years beginning after December 31, 1986.* A return required by § 55.6011–1 for any calendar year beginning after December 31, 1986, shall be filed on or before March 15 of the following calendar year. See § 55.6081–1 for rules relating to extensions of time for filing a return required by § 55.6011–1.

(b) *Returns for excise tax under section 4981 as in effect before amendment by the Tax Reform Act of 1986.* A return required by § 55.6011–1 for any excise tax under section 4981, as in effect before amendment by the Tax Reform Act of 1986, shall be filed at the time (including any extension of time granted or allowed under section 6081) that the real estate investment trust is required to file its income tax return under section 6012 for the taxable year for which the tax under section 4981, as in effect before amendment by the Tax Reform Act of 1986, is imposed.

[T.D. 8180, 53 FR 6148, Mar. 1, 1988]

§ 55.6081–1 Automatic extension of time for filing a return due under Chapter 44.

(a) *In general.* A Real Estate Investment Trust (REIT) required to file a return on Form 8612, ''Return of Excise

Tax on Undistributed Income of Real Estate Investment Trusts,'' or a Regulated Investment Company (RIC) required to file a return on Form 8613, ''Return of Excise Tax on Undistributed Income of Regulated Investment Companies,'' will be allowed an automatic 6-month extension of time to file the return after the date prescribed for filing the return if the REIT or RIC files an application under this section in accordance with paragraph (b) of this section.

(b) *Requirements*. To satisfy this paragraph (b), a REIT or RIC must—

(1) Submit a complete application on Form 7004, ''Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns,'' or in any other manner prescribed by the Commissioner;

(2) File the application on or before the date prescribed for filing the return with the Internal Revenue Service office designated in the application's instructions; and

(3) Remit the amount of the properly estimated unpaid tax liability on or before the date prescribed for payment.

(c) *No extension of time for the payment of tax*. An automatic extension of time for filing a return granted under paragraph (a) of this section will not extend the time for payment of any tax due on such return.

(d) *Termination of automatic extension*. The Commissioner may terminate an automatic extension at any time by mailing to the REIT or RIC a notice of termination at least 10 days prior to the termination date designated in such notice. The Commissioner must mail the notice of termination to the address shown on the Form 7004 or to the REIT or RIC's last known address. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter.

(e) *Penalties*. See section 6651 for failure to file or failure to pay the amount shown as tax on the return.

(f) *Effective/applicable dates*. This section is applicable for applications for an automatic extension of time to file a return due under chapter 44, filed after July 1, 2008.

[T.D. 9407, 73 FR 37369, July 1, 2008]

§ 55.6091–1 Place for filing Chapter 44 tax returns.

Except as provided in § 55.6091–2 (relating to exceptional cases):

(a) *In general*. Chapter 44 tax returns shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office serving the principal place of business or principal office or agency of the real estate investment trust or regulated investment company.

(b) *Returns filed with service centers or by hand carrying*. Notwithstanding paragraph (a) of this section, unless a return is filed by hand carrying, whenever instructions applicable to Chapter 44 tax returns provide that the returns be filed with a service center, the returns must be so filed in accordance with the instructions. Returns which are filed by hand carrying shall be filed with any person assigned the responsibility to receive hand-carried returns in the local Internal Revenue Service office in accordance with paragraph (a) of this section.

[T.D. 7767, 46 FR 11282, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981. Redesignated and amended by T.D. 8180, 53 FR 6148, Mar. 1, 1988; T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 55.6091–2 Exceptional cases.

Notwithstanding the provisions of § 55.6091–1, the Commissioner may permit the filing of any Chapter 44 tax return in any local Internal Revenue Service office.

[T.D. 7767, 46 FR 11282, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981. Redesignated by T.D. 8180, 53 FR 6148, Mar. 1, 1988, as amended by T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 55.6107–1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.

(a) *In general*. A person who is a signing tax return preparer of any return or claim for refund of tax under Chapter 44 of subtitle D of the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the taxpayer, and retain a completed copy or record in the manner stated in § 1.6107–1 of this chapter.

(b) *Effective/applicability date*. This section is applicable to returns and

claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 55.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund.

(a) *In general.* Each tax return or claim for refund of tax under chapter 44 of Subtitle D prepared by one or more signing tax return preparers must include the identifying number of the preparer required by § 1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in § 1.6109–2 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 55.6151–1 Time and place for paying of tax shown on returns.

The tax shown on any return which is imposed by Chapter 44 shall, without notice or assessment and demand, be paid to the internal revenue officer with whom the return is filed at the time and place for filing such return (determined without regard to any extension of time for filing the return). For provisions relating to the time and place for filing such return, see §§ 55.6071–1 and 55.6091–1. For provisions relating to the extension of time for paying the tax see § 55.6161–1.

[T.D. 8180, 53 FR 6148, Mar. 1, 1988]

§ 55.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by Chapter 44 and shown or required to be shown on any return, may be granted by the district directors at the request of the taxpayer. The period of such extension shall not be in excess of 6 months from the date fixed for payment of such tax.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by Chapter 44 may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid. The extension may be for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand. In exceptional cases, a further extension for a period not in excess of 12 months may be granted. No extension of time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished.* The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof unless so specified in the extension.

(b) *Certain rules relating to extension of time for paying income tax to apply.* The provisions of § 1.6161–1 (b), and (c), and (d) of this chapter (relating to a requirement for undue hardship, the application for extension, and payment pursuant to an extension) shall apply to extensions of time for payment of the tax imposed by Chapter 44.

§ 55.6165–1 Bonds where time to pay tax or deficiency has been extended.

If an extension of time for payment of tax or deficiency is granted under section 6161, the district director or the director of the service center may, if he deems it necessary, require a bond for the payment of the amount in respect of which the extension is granted in accordance with the terms of the extension. However, the bond shall not exceed double the amount with respect to which the extension is granted. For provisions relating to form of bonds, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

§ 55.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general.* For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund of tax under chapter 44 of Subtitle D see § 1.6694–1 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to

returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 55.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of excise tax under chapter 44 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 55.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under chapter 44 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78459, Dec. 22, 2008]

§ 55.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection when a tax return preparer who prepared a return or claim for refund for excise tax under chapter 44 of subtitle D of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 55.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under chapter 44 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 55.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules for claims for credit or refund by a tax return preparer who prepared a return or claim for refund for tax under chapter 44 of subtitle D of the Internal Revenue Code, the rules under § 1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 55.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see § 301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

PART 56—PUBLIC CHARITY EXCISE TAXES

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56.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.
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56.7701–1 Tax return preparer.

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Section 56.4911–7 also issued under 26 U.S.C. 4911(f)(3);

Section 56.6060–1 also issued under 26 U.S.C. 6060(a);

Section 56.6109–1 also issued under 26 U.S.C. 6109(a);

Section 56.6109–2 also issued under 26 U.S.C. 6109(a);

Section 56.6695–1 also issued under 26 U.S.C. 6695(b).

SOURCE: T.D. 8308, 55 FR 35598, Aug. 31, 1990, unless otherwise noted.

§ 56.4911–0 Outline of regulations under section 4911.

Immediately following is an outline of the regulations under section 4911 of the Internal Revenue Code relating to an excise tax on electing public charities' excess lobbying expenditures.

§ 56.4911–0 Outline of regulations under section 4911.

§ 56.4911–1 Tax on excess lobbying expenditures.

(a) In general.
(b) Excess lobbying expenditures.
(c) Nontaxable amounts.
(1) Lobbying nontaxable amount.
(2) Grass roots nontaxable amount.
(d) Examples.

§ 56.4911–2 Lobbying expenditures, direct lobbying communications, and grass roots lobbying communications.

(a) Lobbying expenditures.
(1) In general.
(2) Overview of § 56.4911 and the definitions of ''direct lobbying communication'' and ''grass roots lobbying communication''.
(b) Influencing legislation: direct and grass roots lobbying communications defined.
(1) Direct lobbying communication.
(2) Grass roots lobbying communication.
(3) Exceptions to the definition of influencing legislation.
(4) Examples.
(5) Special rule for certain mass media advertisements.
(c) Exceptions to the definitions of direct lobbying communication and grass roots lobbying communication.
(1) Nonpartisan analysis, study, or research exception.
(2) Examinations and discussions of broad social, economic, and similar problems.
(3) Requests for technical advice.
(4) Communications pertaining to ''self-defense'' by the organization.
(d) Definitions.
(1) Legislation.
(2) Action.
(3) Legislative body.
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§ 56.4911–3 Expenditures for direct and/or grass roots lobbying communications.

(a) Definition of term ''expenditures for''.
(1) In general.
(2) Allocation of mixed purpose expenditures.
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(b) Examples.
(c) Certain transfers treated as lobbying expenditures.
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(2) Transfer earmarked for direct and grass roots lobbying.
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§ 56.4911–4 Exempt purpose expenditures.

(a) Application.
(b) Included expenditures.
(c) Excluded expenditures.
(d) Certain transfers treated as exempt purpose expenditures.
(e) Transfers not exempt purpose expenditures.
(f) Definitions.
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§ 56.4911–5 Communications with members.

(a) In general.
(b) Communications (directed only to members) that are not lobbying communications.
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(d) Communications (directed only to members) that are grass roots lobbying communications.
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(1) In general.
(2) Direct lobbying directly encouraged.
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(4) No direct encouragement of direct lobbying or of grass roots lobbying.
(f) Definitions and special rules.
(1) Member; general rule.
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(3) Member; affiliated group of organizations.
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(5) Subscriber.
(6) Directly encourages.
(7) Percentages of total distribution.
(8) Reasonable allocation rule.

§ 56.4911–6 Records of lobbying and grass roots expenditures.

(a) Records of lobbying expenditures.
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§ 56.4911–7 Affiliated group of organizations.

(a) Affiliation between two organizations.
(1) In general.
(2) Organizations not described in section 501(c)(3).
(3) Action on legislative issues.
(b) Interlocking governing boards.
(1) In general.
(2) Majority or quorum.
(3) Votes required under governing instrument or local law.
(4) Representatives constituting less than 15% of governing board.
(5) Representatives.
(c) Governing instrument.
(d) Three or more organizations affiliated.
(1) Two controlled organizations affiliated.
(2) Chain rule.
(e) Affiliated group of organizations.
(1) Defined.
(2) Multiple membership.
(3) Taxable year of affiliated group.
(4) Electing member organization.
(5) Election of member's year as group's taxable year.
(f) Examples.

§ 56.4911–8 Excess lobbying expenditures of affiliated group.

(a) Application.
(b) Affiliated group treated as one organization.
(c) Tax imposed on excess lobbying expenditures of affiliated group.
(d) Liability for tax.
(1) Electing organizations.
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(6) Organization a member of more than one affiliated group.
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§ 56.4911–9 Application of section 501(h) to affiliated groups of organizations.

(a) Scope.
(b) Determination required.
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(d) Filing of information relating to affiliated group of organizations.
(1) Scope.
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(3) Additional information required.
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§ 56.4911–10 Members of a limited affiliated group of organizations.

(a) Scope.
(b) Members of limited affiliated group.
(c) Controlling and controlled organizations.
(d) Expenditures of controlling organization.
(1) Scope.
(2) Expenditures for direct lobbying.
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(e) Expenditures of controlled member.
(f) Reports of members of limited affiliated groups.
(1) Controlling member organization's additional information on annual return.
(2) Reports of controlling members to other members.
(3) Reports of controlled member organizations.
(g) National legislative issues.
(h) Examples.

§ 56.6001–1 Notice or regulations requiring records, statements, and special returns.

(a) In general.
(b) Cross references.

§ 56.6011–1 General requirement of return, statement, or list.

§ 56.4911–1 Tax on excess lobbying expenditures.

(a) *In general.* Section 4911(a) imposes an excise tax of 25 percent on the excess lobbying expenditures (as defined in paragraph (b) of this section) for a taxable year of an organization for which the expenditure test election under section 501(h) is in effect (an ''electing public charity''). An electing public charity's annual limit on expenditures for influencing legislation (*i.e.*, the amount of lobbying expenditures on which no tax is due) is the lobbying nontaxable amount or, on expenditures for influencing legislation through grass roots lobbying, the grass roots nontaxable amount (see paragraph (c) of this section). For rules concerning the application of the excise tax imposed by section 4911(a) to the members of an affiliated group of organizations (as defined in § 56.4911–7(e)), see § 56.4911–8.

(b) *Excess lobbying expenditures.* For any taxable year for which the expenditure test election under section 501(h) is in effect, the amount of an electing public charity's excess lobbying expenditures is the greater of—

(1) The amount by which the organization's lobbying expenditures (within the meaning of § 56.4911–2(a)) exceed the organization's lobbying nontaxable amount, or

(2) The amount by which the organization's grass roots expenditures (within the meaning of §§ 56.4911–2(a)) exceed the organization's grass roots nontaxable amount.

(c) *Nontaxable amounts*—(1) *Lobbying nontaxable amount.* Under section 4911(c)(2), the lobbying nontaxable amount for any taxable year for which the expenditure test election is in effect is the lesser of—

(i) $1,000,000, or

(ii) To the extent of the electing public charity's exempt purpose expenditures (within the meaning of § 56.4911–4) for that year, the sum of 20 percent of the first $500,000 of such expenditures, plus 15 percent of the second $500,000 of such expenditures, plus 10 percent of the third $500,000 of such expenditures, plus 5 percent of the remainder of such expenditures.

(2) *Grass roots nontaxable amount.* Under section 4911(c)(4), an electing public charity's grass roots nontaxable amount for any taxable year is 25 percent of its lobbying nontaxable amount for that year.

(d) *Examples.* The provisions of this section are illustrated by the examples in § 1.501(h)–3.

§ 56.4911–2 Lobbying expenditures, direct lobbying communications, and grass roots lobbying communications.

(a) *Lobbying expenditures*—(1) *In general.* An electing public charity's lobbying expenditures for a year are the sum of its expenditures during that year for direct lobbying communications (''direct lobbying expenditures'') plus its expenditures during that year for grass roots lobbying communications (''grass roots expenditures'').

(2) *Overview of § 56.4911–2 and the definitions of ''direct lobbying communication'' and ''grass roots lobbying communication''.* Paragraph (b)(1) of this section defines the term ''direct lobbying communication.'' Paragraph (b)(2) of this section provides the general definition of the term ''grass roots lobbying communication.'' (But also see paragraph (b)(5) of this section (special rebuttable presumption regarding certain paid mass media communications) and § 56.4911–5 (special, more lenient, definitions for certain communications from an electing public charity to its bona fide members)). Paragraph (b)(3) of this section lists and cross-references various exceptions to the definitions set forth in paragraphs (b) (1)

and (2) (the text of the exceptions, along with relevant definitions and examples, is generally set forth in paragraph (c)). Paragraph (b)(4) of this section contains numerous examples illustrating the application of paragraphs (b) (1), (2) and (3). As mentioned above, paragraph (b)(5) of this section sets forth the special rebuttable presumption regarding a limited number of paid mass media communications about highly publicized legislation. Paragraph (d) of this section contains definitions of (and examples illustrating) various terms used in this section.

(b) *Influencing legislation: direct and grass roots lobbying communications defined*—(1) *Direct lobbying communication*—(i) *Definition*. A direct lobbying communication is any attempt to influence any legislation through communication with:

(A) Any member or employee of a legislative body; or

(B) Any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the communication is to influence legislation.

(ii) *Required elements*. A communication with a legislator or government official will be treated as a direct lobbying communication under this § 56.4911–2(b)(1) if, but only if, the communication:

(A) Refers to specific legislation (see paragraph (d)(1) of this section for a definition of the term ''specific legislation''); and

(B) Reflects a view on such legislation.

(iii) *Special rule for referenda, ballot initiatives or similar procedures*. Solely for purposes of this section 4911, where a communication refers to and reflects a view on a measure that is the subject of a referendum, ballot initiative or similar procedure, the general public in the State or locality where the vote will take place constitutes the legislative body, and individual members of the general public area, for purposes of this paragraph (b)(1), legislators. Accordingly, if such a communication is made to one or more members of the general public in that state or locality, the communication is a direct lobbying communication (unless it is nonpartisan analysis, study or research (see paragraph (c)(1) of this section).

(2) *Grass roots lobbying communication*—(i) *Definition*. A grass roots lobbying communication is any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof.

(ii) *Required elements*. A communication will be treated as a grass roots lobbying communication under this § 56.4911–2(b)(2)(ii) if, but only if, the communication:

(A) Refers to specific legislation (see paragraph (d)(1) of this section for a definition of the term ''specific legislation'');

(B) Reflects a view on such legislation; and

(C) Encourages the recipient of the communication to take action with respect to such legislation (see paragraph (b)(2)(iii) of this section for the definition of encouraging the recipient to take action.

For special, more lenient rules regarding an organization's communications directed only or primarily to bona fide members of the organization, see § 56.4911–5. For special rules regarding certain paid mass media advertisements about highly publicized legislation, see paragraph (b)(5) of this section. For special rules regarding lobbying on referenda, ballot initiatives and similar procedures, see paragraph (b)(1)(iii) of this section).

(iii) *Definition of encouraging recipient to take action*. For purposes of this section, encouraging a recipient to take action with respect to legislation means that the communication:

(A) States that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(B) States the address, telephone number, or similar information of a legislator or an employee of a legislative body;

(C) Provides a petition, tear-off postcard or similar material for the recipient to communicate with a legislator or an employee of a legislative body, or with any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation); or

(D) Specifically identifies one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Encouraging the recipient to take action under this paragraph (b)(2)(iii)(D) does not include naming the main sponsor(s) of the legislation for purposes of identifying the legislation.

(iv) *Definition of directly encouraging recipient to take action.* Communications described in one or more of paragraphs (b)(2)(iii) (A) through (C) of this section not only ''encourage,'' but also ''directly encourage'' the recipient to take action with respect to legislation. Communications described in paragraph (b)(2)(iii)(D) of this section, however, do not directly encourage the recipient to take action with respect to legislation. Thus, a communication would encourage the recipient to take action with respect to legislation, but not directly encourage such action, if the communication does no more than identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Communications that encourage the recipient to take action with respect to legislation but that do not directly encourage the recipient to take action with respect to legislation may be within the exception for nonpartisan analysis, study or research (se paragraph (c)(1) of this section) and thus not be grass roots lobbying communications.

(v) *Subsequent lobbying use of nonlobbying communications or research materials*—(A) *Limited effect of application.* Even though certain communications or research materials are initially not grass roots lobbying communications under the general definition set forth in paragraph (b)(2)(ii) of this section, subsequent use of the communications or research materials for grass roots lobbying may cause them to be treated as grass roots lobbying communications. This paragraph (b)(2)(v) does not cause any communications or research materials to be considered direct lobbying communications.

(B) *Limited scope of application.* Under this paragraph (b)(2)(v), only ''advocacy communications or research materials'' are potentially treated as grass roots lobbying communications. Communications or research materials that are not ''advocacy communications or research materials'' are not treated as grass roots lobbying communications under this paragraph (b)(2)(v). ''Advocacy communications or research materials'' are any communications or materials that both refer to and reflect a view on specific legislation but that do not, in their initial format, contain a direct encouragement for recipients to take action with respect to legislation.

(C) *Subsequent use in lobbying.* Where advocacy communications or research materials are subsequently accompanied by a direct encouragement for recipients to take action with respect to legislation, the advocacy communications or research materials themselves are treated as grass roots lobbying communications unless the organization's primary purpose in undertaking or preparing the advocacy communications or research materials was not for use in lobbying. In such a case, all expenses of preparing and distributing the advocacy communications or research materials will be treated as grass roots expenditures.

(D) *Time limit on application of subsequent use rule.* The characterization of expenditures as grass roots lobbying expenditures under paragraph (b)(2)(v)(C) shall apply only to expenditures paid less than six months before

the first use of the advocacy communications or research materials with a direct encouragement to action.

(E) *Safe harbor in determining ''primary purpose''*. The primary purpose of the organization in undertaking or preparing advocacy communications or research materials will not be considered to be for use in lobbying if, prior to or contemporaneously with the use of the advocacy communications or research materials with the direct encouragement to action, the organization makes a substantial nonlobbying distribution of the advocacy communications or research materials (without the direct encouragement to action). Whether a distribution is substantial will be determined by reference to all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan analyses, studies or research by that and similar organizations.

(F) *Special rule for partisan analysis, study or research*. In the case of advocacy communications or research materials that are not nonpartisan analysis, study or research, the nonlobbying distribution thereof will not be considered ''substantial'' unless that distribution is at least as extensive as the lobbying distribution thereof.

(G) *Factors considered in determining primary purpose*. Where the nonlobbying distribution of advocacy communications or research materials is not substantial, all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the advocacy communications or research materials was for use in lobbying. While not the only factor, the extent of the organization's nonlobbying distribution of the advocacy communications or research materials is particularly relevant, especially when compared to the extent of their distribution with the direct encouragement to action. Another particularly relevant factor is whether the lobbying use of the advocacy communications or research materials is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence (which must include evidence demonstrating cooperation or collusion between the two organizations) will be required to establish that the primary purpose for preparing the communication for use in lobbying.

(H) *Examples*. The provisions of this paragraph (b)(2)(v) are illustrated by the following examples:

Example 1. Assume a nonlobbying ''report'' (that is not nonpartisan analysis, study or research) is prepared by an organization, but distributed to only 50 people. The report, in that format, refers to and reflects a view on specific legislation but does not contain a direct encouragement for the recipients to take action with respect to legislation. Two months later, the organization sends the report to 10,000 people along with a letter urging recipients to write their Senators about the legislation discussed in the report. Because the report's nonlobbying distribution is not as extensive as its lobbying distribution, the report's nonlobbying distribution is not substantial for purposes of this paragraph (b)(2)(v). Accordingly, the organization's primary purpose in preparing the report must be determined by weighing all of the facts and circumstances. In light of the relatively minimal nonlobbying distribution and the fact that the lobbying distribution is by the preparing organization rather than by an unrelated organization, and in the absence of evidence to the contrary, both the report and the letter are grass roots lobbying communications. Assume that all costs of preparing the report were paid within the six months preceding the mailing of the letter. Accordingly, all of the organization's expenditures for preparing and mailing the two documents are grass roots lobbying expenditures.

Example 2. Assume the same facts as in Example (1), except that the costs of the report are paid over the two month period of January and February. Between January 1 and 31, the organization pays $1,000 for the report. In February, the organization pays $500 for the report. Further assume that the report is first used with a direct encouragement to action on August 1. Six months prior to August 1 is February 1. Accordingly, no costs paid for the report before February 1 are treated as grass roots lobbying expenditures under the subsequent use rule. Under these facts, the subsequent use rule treats only the $500 paid for the report in February as grass roots lobbying expenditures.

(3) *Exceptions to the definition of influencing legislation*. In many cases, a communication is not a direct or grass roots lobbying communication under paragraph (b)(1) or (b)(2) of this section if it falls within one of the exceptions

listed in paragraph (c) of this section. See paragraph (c)(1), Nonpartisan analysis, study or research; paragraph (c)(2), Examinations and discussions of broad social, economic and similar problems; paragraph (c)(3), Requests for technical advice; and paragraph (c)(4), Communications pertaining to self-defense by the organization. In addition, see § 56.4911–5, which provides special rules regarding the treatment of certain lobbying communications directed in whole or in part to members of an electing public charity.

(4) *Examples*. This paragraph (b)(4) provides examples to illustrate the rules set forth in the section regarding direct and grass roots lobbying. The expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b)(4). In addition, it is assumed that the special rules of § 56.4911–5, regarding certain of a public charity's communications with its members, do not apply to any of the examples in this paragraph (b)(4).

(i) *Direct lobbying*. The provisions of this section regarding direct lobbying communications are illustrated by the following examples:

Example 1. Organization P's employee, X, is assigned to approach members of Congress to gain their support for a pending bill. X drafts and P prints a position letter on the bill. P distributes the letter to members of Congress. Additionally, X personally contacts several members of Congress or their staffs to seek support for P's position on the bill. The letter and the personal contacts are direct lobbying communications.

Example 2. Organization M's president writes a letter to the Congresswoman representing the district in which M is headquartered, requesting that the Congresswoman write an administrative agency regarding proposed regulations recently published by that agency. M's president also requests that the Congresswoman's letter to the agency state the Congresswoman's support of M's application for a particular type of permit granted by the agency. The letter written by M's president is not a direct lobbying communication.

Example 3. Organization Z prepares a paper on a particular state's environmental problems. The paper does not reflect a view on any specific pending legislation or on any specific legislative proposal that Z either supports or opposes. Z's representatives give the paper to a state legislator. Z's paper is not a direct lobbying communication.

Example 4. State X enacts a statute that requires the licensing of all day care providers. Agency B in State X is charged with preparing rules to implement the bill enacted by State X. One week after enactment of the bill, organization C sends a letter to Agency B providing detailed proposed rules that organization C suggests to Agency B as the appropriate standards to follow in implementing the statute on licensing of day care providers. Organization C's letter to Agency B is not a lobbying communication.

Example 5. Organization B researches, prepares and prints a code of standards of minimum safety requirements in an area of common electrical wiring. Organization B sells the code of standards booklet to the public and its is widely used by professional in the installation of electrical wiring. A number of states have codified all, or part, of the code of standards as mandatory safety standards. On occasion, B lobbies state legislators for passage of the code of standards for safety reasons. Because the primary purpose of preparing the code of standards was the promotion of public safety and the standards were specifically used in a profession for that purpose, separate from any legislative requirement, the research, preparation, printing and public distribution of the code of standards is not an expenditure for a direct (or grass roots) lobbying communication. Costs, such as transportation, photocopying, and other similar expenses, incurred in lobbying state legislators for passage of the code of standards into law are expenditures for direct lobbying communications.

Example 6. On the organization's own initiative, representatives of Organization F present written testimony to a Congressional committee. The news media report on the testimony of Organization F, detailing F's opposition to a pending bill. The testimony is a direct lobbying communication but is not a grass roots lobbying communication.

Example 7. Organization R's monthly newsletter contains an editorial column that refers to and reflects a view on specific pending bills. R sends the newsletter to 10,000 nonmember subscribers. Senator Doe is among the subscribers. The editorial column in the newsletter copy sent to Senator Doe is not a direct lobbying communication because the newsletter is sent to Senator Doe in her capacity as a subscriber rather than her capacity as a legislator. (NOTE, though, that the editorial column may be a grass roots lobbying communication if it encourages recipients to take action with respect to the pending bills it refers to and on which it reflects a view).

Example 8. Assume the same facts as in Example (7), except that one of Senator Doe's staff members sees Senator Doe's copy of the

editorial and writes to R requesting additional information. R responds with a letter that refers to and reflects a view on specific legislation. R's letter is a direct lobbying communication unless it is within one of the exceptions set forth in paragraph (c) of this section (such as the exception for nonpartisan analysis, study or research). (R's letter is not within the scope of the exception for responses to written requests from a legislative body or committee for technical advice (see paragraph (c)(3) of this section) because the letter is not in response to a written request from a legislative body or committee).

(ii) *Grass roots lobbying*. The provisions of this section regarding grass roots lobbying communications are illustrated in paragraph (b)(4)(ii)(A) of this section by examples of communications that are not grass roots lobbying communications and in paragraph (b)(4)(ii)(B) by examples of communications that are grass roots lobbying communications. The provisions of this section are further illustrated in paragraph (b)(4)(ii)(C), with particular regard to the exception for nonpartisan analysis, study, or research:

(A) *Communications that are not grass roots lobbying communications*.

Example 1. Organization L places in its newsletter an article that asserts that lack of new capital is hurting State W's economy. The article recommends that State W residents either invest more in local businesses or increase their savings so that funds will be available to others interested in making investments. The article is an attempt to influence opinions with respect to a general problem that might receive legislative attention and is distributed in a manner so as to reach and influence many individuals. However, the article does not refer to specific legislation that is pending in a legislative body, nor does the article refer to a specific legislative proposal the organization either supports or opposes. The article is not a grass roots lobbying communication.

Example 2. Assume the same facts as Example (1), except that the article refers to a bill pending in State W's legislature that is intended to provide tax incentives for private savings. The article praises the pending bill and recommends that it be enacted. However, the article does not encourage readers to take action with respect to the legislation. The article is not a grass roots lobbying communication.

Example 3. Organization B sends a letter to all persons on its mailing list. The letter includes an update on numerous environmental issues with a discussion of general concerns regarding pollution, proposed federal regulations affecting the area, and several pending legislative proposals. The letter endorses two pending bills and opposes another pending bill, but does not name any legislator involved (other than the sponsor of one bill, for purposes of identifying the bill), nor does it otherwise encourage the reader to take action with respect to the legislation. The letter is not a grass roots lobbying communication.

Example 4. A pamphlet distributed by organization Z discusses the dangers of drugs and encourages the public to send their legislators a coupon, printed with the statement ''I support a drug-free America.'' The term ''drug-free America'' is not widely identified with any of the many specific pending legislative proposals regarding drug issues. The pamphlet does not refer to any of the numerous pending legislative proposals, nor does the organization support or oppose a specific legislative proposal. The pamphlet is not a grass roots lobbying communication.

Example 5. A pamphlet distributed by organization B encourages readers to join an organization and ''get involved in the fight against drugs.'' The text states, in the course of a discussion of several current drug issues, that organization B supports a specific bill before Congress that would establish an expanded drug control program. The pamphlet does not encourage readers to communicate with legislators about the bill (such as by including the names of undecided or opposed legislators). The pamphlet is not a grass roots lobbying communication.

Example 6. Organization E, an environmental organization, routinely summarizes in each edition of its newsletter the new environment-related bills that have been introduced in Congress since the last edition of the newsletter. The newsletter identifies each bill by a bill number and the name of the legislation's sponsor. The newsletter also reports on the status of previously introduced environment-related bills. The summaries and status reports do not encourage recipients of the newsletter to take action with respect to legislation, as described in paragraphs (b)(2)(iii) (A) through (D) of this section. Although the summaries and status reports refer to specific legislation and often reflect a view on such legislation, they do not encourage the newsletter recipients to take action with respect to such legislation. The summaries and status reports are not grass roots lobbying communications.

Example 7. Organization B prints in its newsletter a report on pending legislation that B supports, the Family Equity bill. The report refers to and reflects a view on the Family Equity bill, but does not directly encourage recipients to take action. Nor does the report specifically identify any legislator as opposing the communication's view on the legislation, as being undecided, or as being a

member of the legislative committee or subcommittee that will consider the legislation. However, the report does state the following:

Rep. Doe (D-Ky.) and Rep. Roe (R-Ma.), both ardent supporters of the Family Equity bill, spoke at B's annual convention last week. Both encouraged B's efforts to get the Family Equity bill enacted and stated that they thought the bill could be enacted even over a presidential veto. B's legislative affairs liaison questioned others, who seemed to agree with that assessment. For example, Sen. Roe (I-Ca.) said that he thinks the bill will pass with such a large majority, ''the President won't even consider vetoing it.''

Assume the newsletter, and thus the report, is sent to individuals throughout the U.S., including some recipients in Kentucky, Massachusetts and California. Because the report is distributed nationally, the mere fact that the report identifies several legislators by party and state as part of its discussion does not mean the report specifically identifies the named legislators as the Kentucky, Massachusetts and California recipients' representatives in the legislature for purposes of paragraph (b)(2)(iii) of this section. The report is not a grass roots lobbying communication.

(B) *Communications that are grass roots lobbying communications.*

Example 1. A pamphlet distributed by organization Y states that the ''President's plan for a drug-free America,'' which will establish a drug control program, should be passed. The pamphlet encourages readers to ''write or call your senators and representatives and tell them to vote for the President's plan.'' No legislative proposal formally bears the name ''President's plan for a drug-free America,'' but that and similar terms have been widely used in connection with specific legislation pending in Congress that was initially proposed by the President. Thus, the pamphlet refers to specific legislation, reflects a view on the legislation, and encourages readers to take action with respect to the legislation. The pamphlet is a grass roots lobbying communication.

Example 2. Assume the same facts as in Example (1), except that the pamphlet does not encourage the public to write or call representatives, but does list the members of the committee that will consider the bill. The pamphlet is a grass roots lobbying communication.

Example 3. Assume the same facts as in Example (1), except that the pamphlet encourages readers to ''write the President to urge him to make the bill a top legislative priority'' rather than encouraging readers to communicate with members of Congress. The pamphlet is a grass roots lobbying communication.

Example 4. Organization B, a nonmembership organization, includes in one of three sections of its newsletter an endorsement of two pending bills and opposition to another pending bill and also identifies several legislators as undecided on the three bills. The section of the newsletter devoted to the three pending bills is a grass roots lobbying communication.

Example 5. Organization D, a nonmembership organization, sends a letter to all persons on its mailing list. The letter includes an extensive discussion concluding that a significant increase in spending for the Air Force is essential in order to provide an adequate defense of the nation. Prior to a concluding fundraising request, the letter encourages readers to write their Congressional representatives urging increased appropriations to build the B–1 bomber. The letter is a grass roots lobbying communication.

Example 6. The President nominates X for a position in the President's cabinet. Organization Y disagrees with the views of X and does not believe X has the necessary administrative capabilities to effectively run a cabinet-level department. Accordingly, Y sends a general mailing requesting recipients to write to four Senators on the Senate Committee that will consider the nomination. The mailing is a grass roots lobbying communication.

Example 7. Organization F mails letters requesting that each recipient contribute money to or join F. In addition, the letters express F's opposition to a pending bill that is to be voted upon by the U.S. House of Representatives. Although the letters are form letters sent as a mass mailing, each letter is individualized to report to the recipient the name of the recipient's congressional representative. The letters are grass roots lobbying communications.

Example 8. Organization C sends a mailing that opposes a specific legislative proposal and includes a postcard addressed to the President for the recipient to sign stating opposition to the proposal. The letter requests that the recipient send to C a contribution as well as the postcard opposing the proposal. C states in the letter that it will deliver all the postcards to the White House. The letter is a grass roots lobbying communication.

(C) *Additional examples.*

Example 1. The newsletter of an organization concerned with drug issues is circulated primarily to individuals who are not members of the organization. A story in the newsletter reports on the prospects for passage of a specifically identified bill, stating that the organization supports the bill. The newsletter story identifies certain legislators as undecided, but does not state that readers should contact the undecided legislators.

The story does not provide a full and fair exposition sufficient to qualify as nonpartisan analysis, study or research. The newsletter story is a grass roots lobbying communication.

Example 2. Assume the same facts as in Example (1), except that the newsletter story provides a full and fair exposition sufficient to qualify as nonpartisan analysis, study or research. The newsletter story is *not* a grass roots lobbying communication because it is within the exception for nonpartisan analysis, study or research (since it does not *directly* encourage recipients to take action).

Example 3. Assume the same facts as in Example (2), except that the newsletter story explicitly asks readers to contact the undecided legislators. Because the newsletter story directly encourages readers to take action with respect to the legislation, the newsletter story is not within the exception for nonpartisan analysis, study or research. Accordingly, the newsletter story is a grass roots lobbying communication.

Example 4. Assume the same facts as in Example (1), except that the story does not identify any undecided legislators. The story is not a grass roots lobbying communication.

Example 5. X organization places an advertisement that specifically identifies and opposes a bill that X asserts would harm the farm economy. The advertisement is not a mass media communication described in paragraph (b)(5)(ii) of this section and does not directly encourage readers to take action with respect to the bill. However, the advertisement does state that Senator Y favors the legislation. Because the advertisement refers to and reflects a view on specific legislation, and also encourages the readers to take action with respect to the legislation by specifically identifying a legislator who opposes X's views on the legislation, the advertisement is a grass roots lobbying communication.

Example 6. Assume the same facts as in Example (5), except that instead of identifying Senator Y as favoring the legislation, the advertisement identifies the ''junior Senator from State Z'' as favoring the legislation. The advertisement is a grass roots lobbying communication.

Example 7. Assume the same facts as in Example (5), except that instead of identifying Senator Y as favoring the legislation, the advertisement states: ''Even though this bill will have a devastating effect upon the farm economy, most of the Senators from the Farm Belt states are inexplicably in favor of the bill.'' The advertisement does not specifically identify one or more legislators as opposing the advertisement's view on the bill in question. Accordingly, the advertisement is not a grass roots lobbying communication because it does not encourage readers to take action with respect to the legislation.

Example 8. Organization V trains volunteers to go door-to-door to seek signatures for petitions to be sent to legislators in favor of a specific bill. The volunteers are wholly unreimbursed for their time and expenses. The volunteers' costs (to the extent any are incurred) are not lobbying or exempt purpose expenditures made by V (but the volunteers may not deduct their out-of-pocket expenditures (see section 170(f)(6)). When V asks the volunteers to contact others and urge them to sign the petitions, V encourages those volunteers to take action in favor of the specific bill. Accordingly, V's costs of soliciting the volunteers' help and its costs of training the volunteers are grass roots expenditures. In addition, the costs of preparing, copying, distributing, etc. the petitions (and any other materials on the same specific subject used in the door-to-door signature gathering effort), are grass roots expenditures.

(5) *Special rule for certain mass media advertisements*—(i) *In general.* A mass media advertisement that is not a grass roots lobbying communication under the three-part grass roots lobbying definition contained in paragraph (b)(2) of this section may be a grass roots lobbying communication by virtue of paragraph (b)(5)(ii) of this section. The special rule in paragraph (b)(5)(ii) generally applies only to a limited type of paid advertisements that appear in the mass media.

(ii) *Presumption regarding certain paid mass media advertisements about highly publicized legislation.* If within two weeks before a vote by a legislative body, or a committee (but not a subcommittee) thereof, on a highly publicized piece of legislation, an organization's paid advertisement appears in the mass media, the paid advertisement will be presumed to be a grass roots lobbying communication, but only if the paid advertisement both reflects a view on the general subject of such legislation and either: refers to the highly publicized legislation; or encourages the public to communicate with legislators on the general subject of such legislation. An organization can rebut this presumption by demonstrating that the paid advertisement is a type of communication regularly made by the organization in the mass media without regard to the timing of legislation (that is, a customary course

of business exception) or that the timing of the paid advertisement was unrelated to the upcoming legislative action. Notwithstanding the fact that an organization successfully rebuts the presumption, a mass media communication described in this paragraph (b)(5)(ii) is a grass roots lobbying communication if the communication would be a grass roots lobbying communication under the rules contained in paragraph (b)(2) of this section.

(iii) *Definitions*—(A) *Mass media*. For purposes of this paragraph (b)(5), the term ''mass media'' means television, radio, billboards and general circulation newspapers and magazines. General circulation newspapers and magazines do not include newspapers or magazines published by an organization for which the expenditure test election under section 501(h) is in effect, except where both: The total circulation of the newspaper or magazine is greater than 100,000; and fewer than one-half of the recipients are members of the organization (as defined in § 56.4911–5(f)).

(B) *Paid advertisement*. For purposes of this paragraph (b)(5), where an electing public charity is itself a mass media publisher or broadcaster, all portions of that organization's mass media publications or broadcasts are treated as paid advertisements in the mass media, except those specific portions that are advertisements paid for by another person. The term ''mass media'' is defined in paragraph (b)(5)(iii)(A).

(C) *Highly publicized*. For purposes of this paragraph (b)(5), ''highly publicized'' means frequent coverage on television and radio, and in general circulation newspapers, during the two weeks preceding the vote by the legislative body or committee. In the case of state or local legislation, ''highly publicized'' means frequent coverage in the mass media that serve the State or local jurisdiction in question. Even where legislation receives frequent coverage, it is ''highly publicized'' only if the pendency of the legislation or the legislation's general terms, purpose, or effect are known to a significant segment of the general public (as opposed to the particular interest groups directly affected) in the area in which the paid mass media advertisement appears.

(iv) *Examples*. The special rule of this paragraph (b)(5) is illustrated by the following examples. The expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b)(5)(iv):

Example 1. Organization X places a television advertisement advocating one of the President's major foreign policy initiatives, as outlined by the President in a series of speeches and as drafted into proposed legislation. The initiative is popularly known as ''the President's World Peace Plan,'' and is voted upon by the Senate four days after X's advertisement. The advertisement concludes: ''SUPPORT THE PRESIDENT'S WORLD PEACE PLAN!'' The President's plan and position are highly publicized during the two weeks before the Senate vote, as evidenced by: coverage of the plan on several nightly television network news program; more than one article about the plan on the front page of a majority of the country's ten largest daily general circulation newspapers; and an editorial about the plan in four of the country's ten largest daily general circulation newspapers. Although the advertisement does not encourage readers to contact legislators or other government officials, the advertisement does refer to specific legislation and reflect a view on the general subject of the legislation. The communication is presumed to be a grass roots lobbying communication.

Example 2. Assume the same facts as in Example (1), except that the advertisement appears three weeks before the Senate's vote on the plan. Because the advertisement appears more than two weeks before the legislative vote, the advertisement is *not* within the scope of the special rule for mass media communications on highly publicized legislation. Accordingly, the advertisement is a grass roots lobbying communication only if it is described in the general definition contained in paragraph (b)(2) of this section. Because the advertisement does not encourage recipients to take action with respect to the legislation in question, the advertisement is not a grass roots lobbying communication.

Example 3. Organization Y places a newspaper advertisement advocating increased government funding for certain public works projects the President has proposed and that are being considered by a legislative committee. The advertisement explains the President's proposals and concludes: ''SUPPORT FUNDING FOR THESE VITAL PROJECTS!'' The advertisement does not encourage readers to contact legislators or other government officials nor does it name any undecided legislators, but it does name

the legislation being considered by the committee. The President's proposed funding of public works, however, is not highly publicized during the two weeks before the vote: there has been little coverage of the issue on nightly television network news programs, only one front-page article on the issue in the country's ten largest daily general circulation newspapers, and only one editorial about the issue in the country's ten largest daily general circulation newspapers. Two days after the advertisement appears, the committee votes to approve funding of the projects. Although the advertisement appears less than two weeks before the legislative vote, the advertisement is *not* within the scope of the special rule for mass media communications on highly publicized legislation because the issue of funding for public works projects is not highly publicized. Thus, the advertisement is a grass roots lobbying communication only if it is described in the general definition contained in paragraph (b)(2) of this section. Because the advertisement does not encourage recipients to take action with respect to the legislation in question, the advertisement is not a grass roots lobbying communication.

Example 4. Organization P places numerous advertisements in the mass media about a bill being considered by the State Assembly. The bill is highly publicized, as evidenced by numerous front-page articles, editorials and letters to the editor published in the state's general circulation daily newspapers, as well as frequent coverage of the bill by the television and radio stations serving the state. The advertisements run over a three week period and, in addition to showing pictures of a family being robbed at gunpoint, say: ''The State Assembly is considering a bill to make gun ownership illegal. This outrageous legislation would violate your constitutional rights and the rights of other law-abiding citizens. If this legislation is passed, you and your family will be criminals if you want to exercise your right to protect yourselves.'' The advertisements refer to and reflect a view on a specific bill but do not encourage recipients to take action. Sixteen days after the last advertisement runs, a State Assembly committee votes to defeat the legislation. None of the advertisements is a grass roots lobbying communication.

Example 5. Assume the same facts as in Example (4), except that it is publicly announced prior to the advertising campaign that the committee vote is scheduled for five days after the last advertisement runs. Because of public pressure resulting from the advertising campaign, the bill is withdrawn and no vote is ever taken. None of the advertisements is a grass roots lobbying communication.

(c) *Exceptions to the definitions of direct lobbying communication and grass roots lobbying communication*—(1) *Nonpartisan analysis, study, or research exception*—(i) *In general.* Engaging in nonpartisan analysis, study, or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work constitute neither a direct lobbying communication under §56.4911–2(b)(1) nor a grass roots lobbying communication under §56.4911–2(b)(2).

(ii) *Nonpartisan analysis, study, or research.* For purposes of this section, ''nonpartisan analysis, study, or research'' means an independent and objective exposition of a particular subject matter, including any activity that is ''educational'' within the meaning of §1.501(c)(3)–1(d)(3). Thus, ''nonpartisan analysis, study, or research'' may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. The mere presentation of unsupported opinion, however, does not qualify as ''nonpartisan analysis, study, or research''.

(iii) *Presentation as part of a series.* Normally, whether a publication or broadcast qualifies as ''nonpartisan analysis, study, or research'' will be determined on a presentation-by-presentation basis. However, if a publication or broadcast is one of a series prepared or supported by an electing organization and the series as a whole meets the standards of paragraph (c)(1)(ii) of this section, then any individual publication or broadcast within the series is not a direct or grass roots lobbying communication even though such individual broadcast or publication does not, by itself, meet the standards of paragraph (c)(1)(ii) of this section. Whether a broadcast or publication is considered part of a series will ordinarily depend upon all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of six consecutive months will oridinarily be eligible to be considered as part of a series. If an electing organization times or channels a part of a series which is described in this

paragraph (c)(1)(iii) in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal, the expenses of preparing and distributing such part of the analysis, study, or research will be expenditures for a direct or grass roots lobbying communications, as the case may be.

(iv) *Making available results of nonpartisan analysis, study, or research.* An organization may choose any suitable means, including oral or written presentations, to distribute the results of its nonpartisan analysis, study, or research, with or without charge. Such means include distribution of reprints of speeches, articles and reports; presentation of information through conferences, meetings and discussions; and dissemination to the news media, including radio, television and newspapers, and to other public forums. For purposes of this paragraph (c)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of certain analysis, study or research.* Even though certain analysis, study or research is initially within the exception for nonpartisan analysis, study or research, subsequent use of that analysis, study or research for grass roots lobbying may cause that analysis, study or research to be treated as a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. This paragraph (c)(1)(v) does not cause any analysis, study or research to be considered a direct lobbying communication. For rules regarding when analysis, study or research is treated as a grass roots lobbying communication that is not within the scope of the exception for nonpartisan analysis, study or research, see paragraph (b)(2)(v) of this section.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception of this paragraph (c)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in one or more of paragraphs (b)(2)(iii) (A) through (C) of this section. As described in paragraph (b)(2)(iv) of this section, a communication would encourage the recipient to take action with respect to legislation, but not directly encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation.

(vii) *Examples.* The provisions of this paragraph (c)(1) may be illustrated by the following examples:

Example 1. Organization M establishes a research project to collect information for the purpose of showing the dangers of the use of pesticides in raising crops. The information collected includes data with respect to proposed legislation, pending before several State legislatures, which would ban the use of pesticides. The project takes favorable positions on such legislation without producing a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion on the pros and cons of the use of pesticides. This project is not within the exception for nonpartisan analysis, study, or research because it is designed to present information merely on one side of the legislative controversy.

Example 2. Organization N establishes a research project to collect information concerning the dangers of the use of pesticides in raising crops for the ostensible purpose of examining and reporting information as to the pros and cons of the use of pesticides in raising crops. The information is collected and distributed in the form of a published report which analyzes the effects and costs of the use and nonuse of various pesticides under various conditions on humans, animals and crops. The report also presents the advantages, disadvantages, and economic cost of allowing the continued use of pesticides unabated, of controlling the use of pesticides, and of developing alternatives to pesticides. Even if the report sets forth conclusions that the disadvantages as a result of using pesticides are greater than the advantages of using pesticides and that prompt legislative regulation of the use of pesticides

is needed, the project is within the exception for nonpartisan analysis, study, or research since it is designed to present information on both sides of the legislative controversy and presents a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion.

Example 3. Organization O establishes a research project to collect information on the presence or absence of disease in humans from eating food grown with pesticides and the presence or absence of disease in humans from eating food not grown with pesticides. As part of the research project, O hires a consultant who prepares a ''fact sheet'' which calls for the curtailment of the use of pesticides and which addresses itself to the merits of several specific legislative proposals to curtail the use of pesticides in raising crops which are currently pending before State Legislatures. The ''fact sheet'' presents reports of experimental evidence tending to support its conclusions but omits any reference to reports of experimental evidence tending to dispute its conclusions. O distributes ten thousand copies to citizens' groups. Expenditures by O in connection with this work of the consultant are not within the exception for nonpartisan analysis, study, or research.

Example 4. P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present such information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example 5. X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

Example 6. Assume the same facts as Example (2), except that, instead of issuing a report, X presents within a period of 6 consecutive months a two-program television series relating to the pesticide issue. The first program contains information, arguments, and conclusions favoring legislation to restrict the use of pesticides. The second program contains information, arguments, and conclusions opposing legislation to restrict the use of pesticides. The programs are broadcast within 6 months of each other during commensurate periods of prime time. X's programs are within the exception for nonpartisan analysis, study, or research. Although neither program individually could be regarded as nonpartisan, the series of two programs constitutes a balanced presentation.

Example 7. Assume the same facts as in Example (6), except that X arranged for televising the program favoring legislation to restrict the use of pesticides at 8:00 on a Thursday evening and for televising the program opposing such legislation at 7:00 on a Sunday morning. X's presentation is not within the exception for nonpartisan analysis, study, or research, since X disseminated its information in a manner prejudicial to one side of the legislative controversy.

Example 8. Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example 9. Assume the same facts as in Example (8), except that, after stating support for the pending bill, the study concludes:

''You should write to the undecided committee members to support this crucial bill.'' The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example 10. Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in § 56.4911–2(c)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of § 56.4911–2(b)(2)(v)(E)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research.

Example 11. Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications.

Example 12. Organization M pays for a bumper sticker that reads: ''STOP ABORTION: Vote NO on Prop. X!'' M also pays for a 30-second television advertisement and a billboard that similarly advocate opposition to Prop. X. In light of the limited scope of the communications, none of the communications is within the exception for nonpartisan analysis, study or research. First, none of the communications rises to the level of analysis, study or research. Second, none of the communications is nonpartisan because none contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. Thus, each communication is a direct lobbying communication.

(2) *Examinations and discussions of broad social, economic, and similar problems.* Examinations and discussions of broad social, economic, and similar problems are neither direct lobbying communications under § 56.4911–2(b)(1) nor grass roots lobbying communications under § 56.4911–2(b)(2) even if the problems are of the type with which government would be expected to deal ultimately. Thus, under §§ 56.4911–2(b)(1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation. For example, this paragraph (c)(2) excludes from grass roots lobbying under § 56.4911–2(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a

legislative body, or a government official or employee who may participate in the formulation of legislation.

(3) *Requests for technical advice.* A communication is not a direct lobbying communication under §56.4911–2(b)(1) if the communication is the providing of technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either in response to a written request by the body, committee, or subdivision, as set forth in §53.4945–2(d)(2).

(4) *Communications pertaining to ''self-defense'' by the organization.* A communication is not a direct lobbying communication under §56.4911–2(b)(1) if either:

(i) The communication is an appearance before, or communication with, any legislative body with respect to a possible action by the body that might affect the existence of the electing public charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to the organization, as set forth in §53.4945–2(d)(3);

(ii) The communication is by a member of an affiliated group of organizations (within the meaning of §56.4911–7(e)), and is an appearance before, or communication with, a legislative body with respect to a possible action by the body that might affect the existence of any other member of the group, its powers and duties, its tax-exempt status, or the deductibility of contributions to it;

(iii) The communication is by an electing public charity more than 75 percent of the members of which are other organizations that are described in section 501(c)(3), and is an appearance before, or communication with, any legislative body with respect to a possible action by the body which might affect the existence of one or more of the section 501(c)(3) member organizations, their powers, duties, or tax-exempt status, or the deductibility (under section 170) of contributions to one or more of the section 501(c)(3) member organizations, but only if the principal purpose of the appearance or communication is to defend the section 501(c)(3) member organizations (rather than the non-section 501(c)(3) member organizations); or

(iv) The communication is by an electing public charity that is a member of a limited affiliated group or organizations under §56.4911–10, and is an appearance before, or communication with, the Congress of the United States with respect to a possible action by the Congress that might affect the existence of any member of the limited affiliated group, its powers and duties, tax-exempt status, or the deductibility of contributions to it.

(v) Under the self-defense exception of paragraphs (c)(4) (i) through (iv) of this section, a charity may communicate with an entire legislative body, with committees or subcommittees of a legislative body, with individual legislators, with legislative staff members, or with representatives of the executive branch who are involved with the legislative process, so long as such communication is limited to the prescribed subjects. Similarly, under the self-defense exception, a charity may make expenditures in order to initiate legislation if such legislation concerns only matters which might affect the existence of the charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to such charity. For examples illustrating the application and scope of the self-defense exception of this paragraph (c)(4), see §53.4945–2(d)(3)(ii).

(d) *Definitions.* For purposes of section 4911 and the regulations thereunder—

(1) *Legislation*—(i) *In general.* ''Legislation'' includes action by the Congress, any state legislature, any local council, or similar legislative body, or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. ''Legislation'' includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

(ii) *Definition of specific legislation.* For purposes of paragraphs (b)(1) and (b)(2) of this section, ''specific legislation'' includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports

or opposes. In the case of a referendum, ballot initiative, constitutional amendment, or other measure that is placed on the ballot by petitions signed by a required number or percentage of voters, an item becomes ''specific legislation'' when the petition is first circulated among voters for signature.

(iii) *Examples.* The terms ''legislation'' and ''specific legislation'' are illustrated using the following examples:

Example 1. A nonmembership organization includes in its newsletter an article about problems with the use of pesticide X that states in part: ''Legislation that is pending in Congress would prohibit the use of this very dangerous pesticide. Fortunately, the legislation will probably be passed. Write your congressional representatives about this important issue.'' This is a grass roots lobbying communication that refers to and reflects a view on specific legislation and that encourages recipients to take action with respect to that legislation.

Example 2. An organization based in State A notes in its newsletter that State Z has passed a bill to accomplish a stated purpose and then says that State A should pass such a bill. The organization urges readers to write their legislators in favor of such a bill. No such bill has been introduced into the State A legislature. The organization has referred to and reflected a view on a specific legislative proposal and has also encouraged readers to take action thereon.

(2) *Action.* The term ''action'' in paragraph (d)(1)(i) of this section is limited to the introduction, amendment, enactment, defeat or repeal of Acts, bills, resolutions, or similar items.

(3) *Legislative body.* ''Legislative body'' does not include executive, judicial, or administrative bodies.

(4) *Administrative bodies.* ''Administrative bodies'' includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive. Thus, for example, for purposes of section 4911, the term ''any attempt to influence any legislation'' does not include attempts to persuade an executive body or department to form, support the formation of, or to acquire property to be used for the formation or expansion of, a public park or equivalent preserves (such as public recreation areas, game, or forest preserves, and soil demonstration areas) established or to be established by act of Congress, by executive action in accordance with an act of Congress, or by a State, municipality or other governmental unit described in section 170(c)(1), as compared with attempts to persuade a legislative body, a member thereof, or other governmental official or employee, to promote the appropriation of funds for such an acquisition or other legislative authorization of such an acquisition. Therefore, for example, an organization would not be influencing legislation for purposes of section 4911, if it proposed to a Park Authority that it purchase a particular tract of land for a new park, even though such an attempt would necessarily require the Park Authority eventually to seek appropriations to support a new park. However, in such a case, the organization would be influencing legislation, for purposes of section 4911, if it provided the Park Authority with a proposed budget to be submitted to a legislative body, unless such submission is described by one of the exceptions set forth in paragraph (c) of this section.

§ 56.4911–3 Expenditures for direct and/or grass roots lobbying communications.

(a) *Definition of term ''expenditures for''*—(1) *In general.* This § 56.4911–3 contains allocation rules regarding what portion of a lobbying communication's costs is a direct lobbying expenditure, what portion is a grass roots expenditure and what portion is, in certain cases, a nonlobbying expenditure. Except as otherwise indicated in this paragraph (a), all costs of preparing a direct or grass roots lobbying communication are included as expenditures for direct or grass roots lobbying. Expenditures for a direct or grass roots lobbying communication (''lobbying expenditures'') include amounts paid or incurred as current or deferred compensation for an employee's services attributable to the direct or grass roots lobbying communication, and the allocable portion of administrative, overhead, and other general expenditures attributable to the direct or grass roots lobbying communication.

For example, except as otherwise provided in this paragraph (a), all expenditures for researching, drafting, reviewing, copying, publishing and mailing a direct or grass roots lobbying communication, as well as an allocable share of overhead expenses, are included as expenditures for direct or grass roots lobbying.

(2) *Allocation of mixed purpose expenditures*—(i) *Nonmembership communications*. Except as provided in paragraph (a)(2)(ii) of this section, lobbying expenditures for a communication that also has a bona fide nonlobbying purpose must include all costs attributable to those parts of the communication that are on the same specific subject as the lobbying message. All costs attributable to those parts of the communication that are not on the same specific subject as the lobbying message are not included as lobbying expenditures for allocation purposes. Whether or not a portion of a communication is on the same specific subject as the lobbying message will depend on the surrounding facts and circumstances. In general, a portion of a communication will be on the same specific subject as the lobbying message if that portion discusses an activity or specific issue that would be directly affected by the specific legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of the specific legislation, or discussion of the background or consequences of an activity or specific issue affected by the specific legislation, is also considered to be on the same specific subject as the lobbying communication.

(ii) *Membership communications*. In the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an electing public charity must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. An electing public charity that includes as a lobbying expenditure only the amount expended for the specific sentence or sentences that encourage the recipient to take action with respect to legislation has not made a reasonable allocation. For purposes of this paragraph, a communication is sent only or primarily to members if more than half of the recipients of the communication are members of the electing public charity making the communication within the meaning of §56.4911–5. See §56.4911–5 for separate rules on communications sent only or primarily to members. Nothing in this paragraph (a) shall change any allocation required by §56.4911–5.

(3) *Allocation of mixed lobbying*. If a communication (to which §56.4911–5 does not apply) is both a direct lobbying communication and a grass roots lobbying communication, the communication will be treated as a grass roots lobbying communication except to the extent that the electing public charity demonstrates that the communication was made primarily for direct lobbying purposes, in which case a reasonable allocation shall be made between the direct and the grass roots lobbying purposes served by the communication.

(b) *Examples*. The provisions of paragraph (a) of this section are illustrated by the following examples. Except where otherwise explicitly stated, the expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b). See §56.4911–5 for special rules applying to the member communications described in some of the following examples.

Example 1. Organization R makes the services of E, one of its paid executives, available to S, an organization described in section 501(c)(4) of the Code. E works for several weeks to assist S in developing materials that urge voters to contact their congressional representatives to indicate their support for specific legislation. In performing this work, E uses office space and clerical assistance provided by R. R pays full salary and benefits to E during this period and receives no reimbursement from S for these payments or for the other facilities and assistance provided. All expenditures of R, including allocable office and overhead expenses, that are attributable to this assignment are grass roots expenditures because E was engaged in an attempt to influence legislation.

Example 2. An organization distributes primarily to nonmembers a pamphlet with two articles on unrelated subjects. The total cost of preparing, printing and mailing the pamphlet is $11,000, $1,000 for preparation and $10,000 for printing and mailing. The cost of

preparing one article, a nonlobbying communication, is $600. The article is printed on three of the four pages in the pamphlet. The cost of preparing the second article, a grass-roots lobbying communication that addresses only one specific subject, is $400. This article is printed on one page of the four page pamphlet. In this situation, $400 of preparation costs and $2,500 (25% of $10,000) of printing and mailing costs are expenditures for a grass roots lobbying communication.

Example 3. Assume the same facts as in Example (2), except that the pamphlet is distributed only to members. In addition, assume the second article states that the recipient members should contact their congressional representatives. The organization allocates $400 of preparation costs and $2,500 of printing and mailing costs as expenditures for direct lobbying (see § 56.4911–5(c)). The allocation is reasonable for purposes of § 56.4911–3(a)(2)(ii).

Example 4. Organization J places a full-page advertisement in a newspaper. The advertisement urges passage of pending legislation to build three additional nuclear powered submarines, and states that readers should write their Congressional representatives in favor of the legislation. The advertisement also provides a general description of J's purposes and activities, invites readers to become members of J and asks readers to contribute money to J. Except for the cost of the portion of the advertisement describing J's purposes and activities and the portion specifically seeking members and contributions, the entire cost of the advertisement is an expenditure for a grass roots lobbying communication, because the entire advertisement, except for the lines specifically describing J and specifically seeking members and contributions, is on the same specific subject as the grass roots lobbying message.

Example 5. Assume the same facts as in Example (4), except that J places in the newspaper two separate half-page advertisements instead of one full-page advertisement. One of the two advertisements discusses the need for three additional nuclear powered submarines and urges readers to write their Congressional representatives in favor of the pending legislation to build the three submarines. The other advertisement contains only the membership and fundraising appeals, along with a general description of J's purposes and activities. The half-page advertisement urging readers to write to Congress is a grass roots lobbying communication and all of J's expenditures for producing and placing that advertisement are expenditures for a grass roots lobbying communication. J's expenditures for the other half-page advertisement are not expenditures for a grass roots or direct lobbying communication.

Example 6. Assume the same facts as in Example (4), except that the communication by J is in a letter mailed only to members of J, rather than in newspaper advertisement, and the invitation to become a member of J is an invitation to join a new membership category. In addition, assume that the communication states that the member recipients should ask nonmembers to write their Congressional representatives. J allocates one-half of the cost of the mailing as an expenditure for a grass roots lobbying communication (see § 56.4911–5(d)). Because the communication had both bona fide nonlobbying (e.g., membership solicitation and fundraising) purposes as well as lobbying purposes, J's allocation of one-half of the cost of the communication to grass roots lobbying and one-half to nonlobbying is reasonable for purposes of § 56.4911–3(a)(2)(ii).

Example 7. A particular monthly issue of organization X's newsletter, which is distributed mainly to nonmembers of X, has three articles of equal length. The first article is a grass roots lobbying communication, the sole specific subject of which is pending legislation to help protect seals from being slaughtered in certain foreign countries. The second article discusses the rapid decline in the world's whale population, particularly because of the illegal hunting of whales by foreign countries. The third article deals with air pollution and the acid rain problem in North America. Because the first article is a grass roots lobbying communication, all of the costs allocable to that article (e.g., one-third of the newsletter's printing and mailing costs) are lobbying expenditures. The second article is not a lobbying communication and the pending legislation relating to seals addressed in the first article does not affect the illegal whale hunting activities. Because the second and third articles are not lobbying communications and are also not on the same specific subject as the first article, no portion of the costs attributable to those articles is a grass roots lobbying expenditure.

Example 8. Organization T, a nonmembership organization, prepares a three page document that is mailed to 3,000 persons on T's mailing list. The first two pages of the three page document, titled ''The Need for Child Care,'' support the need for additional child care programs, and include statistics on the number of children living in homes where both parents work or in homes with a single parent. The two pages also make note of the inadequacy of the number of day care providers to meet the needs of these parents. The third page of the document, titled ''H.R. 1,'' indicates T's support of H.R. 1, a bill pending in the U.S. House of Representatives. The document states that H.R. 1 will provide for $10,000,000 in additional subsidies to child care providers, primarily for those providers caring for lower income children. The third page of the document also notes that H.R. 1 includes new federal standards

regulating the quality of child care providers. The document ends with T's request that recipients contact their congressional representative in support of H.R. 1. The entire three page document is on the same specific subject, and, therefore, all expenditures of preparing and distributing the three page document are grass roots lobbying expenditures.

Example 9. Assume the same facts as in Example (8), except that the document has a fourth page. The fourth page does not refer to the general need for child care or the specific need for additional child care providers. Instead, the fourth page advocates that a particular federal agency commence, under its existing statutory authority, licensing of day care providers in order to promote safe and effective child care. The cost of the fourth page is not a lobbying expenditure.

Example 10. Assume the same facts as in Example (8), except that T is a membership organization, 75 percent of the recipients of the three page document are members of T, and 25 percent of the recipients are nonmembers and are not subscribers within the meaning of § 56.4911–5(f)(5). Assume also that the document states that readers should write to Congress, but does not state that the readers should urge nonmembers to write to Congress. T treats the document as having a bona fide nonlobbying purpose, the purpose of educating its members about the need for child care. Accordingly, T allocates one-half of the cost of preparing and distributing the document as a lobbying expenditure (see § 56.4911–5(e)(2)(i)), of which 75 percent is a direct lobbying expenditure (see § 56.4911–5(e)(2)(iii)) and 25 percent is a grass roots lobbying expenditure (see § 56.4911–5(e)(2)(ii)). The remaining one-half is allocated as a nonlobbying expenditure. T's allocation is reasonable for purposes of § 56.4911–3(a)(2)(ii) and is correct for purposes of § 56.4911–5(e).

Example 11. Assume the same facts as in Example (10), except that T allocates one percent of the cost of preparing and distributing the document as a lobbying expenditure (for purposes of § 56.4911–5(e)(2)) and 99 percent as a nonlobbying expenditure. T's allocation is based upon the fact that out of 200 lines in the document, only two lines state that the recipient should contact legislators about the pending legislation. T's allocation is unreasonable for purposes of § 56.4911–3(a)(2)(ii).

Example 12. Organization F, a nonmembership organization, sends a one page letter to all persons on its mailing list. The only subject of the letter is the organization's opposition to a pending bill allowing private uses of certain national parks. The letter requests recipients to send letters opposing the bill to their congressional representatives. A second one page letter is sent in the same envelope. The second letter discusses the broad educational activities and publications of the organization in all areas of environmental protection and ends by requesting the recipient to make a financial contribution to organization F. Since the separate second letter is on a different subject from the lobbying letter, and the letters are of equal length, 50 percent of the mailing costs must be allocated as an expenditure for a grass roots lobbying communication.

Example 13. Assume the same facts as in Example (12), except that F is a membership organization and the letters in question are sent primarily (90 percent) to members. The other 10 percent of the recipients are nonmembers and are not subscribers within the meaning of § 56.4911–5(f)(5). Assume also that the first letter does not state that readers should urge nonmembers to write to legislators. F allocates one-half of the mailing costs as a lobbying expenditure, of which 90 percent is a direct lobbying expenditure and 10 percent is a grass roots lobbying expenditure (see § 56.4911–5(e)(2)). F's allocation is reasonable for purposes of § 56.4911–3(a)(2)(ii) and is correct for purposes of § 56.4911–5.

(c) *Certain transfers treated as lobbying expenditures*—(1) *Transfer earmarked for grass roots purposes.* A transfer is a grass roots expenditure to the extent that it is earmarked (as defined in § 56.4911–4(f)(4)) for grass roots lobbying purposes and is not described in § 56.4911–4(e).

(2) *Transfer earmarked for direct and grass roots lobbying.* A transfer that is earmarked for direct lobbying purposes or for direct lobbying and grass roots lobbying purposes is treated as a grass roots expenditure in full except to the extent the transferor demonstrates that all or part of the amounts transferred were expended for direct lobbying purposes, in which case that part of the amounts transferred is a direct lobbying expenditure by the transferor. This paragraph (c)(2) shall not apply to any expenditure described in § 56.4911–4(e).

(3) *Certain transfers to noncharities that lobby*—(i) *Limited application of paragraph (c)(3)*—(A) *In general.* This paragraph (c)(3) applies only to transfers for less than fair market value from an electing public charity to any noncharity that makes lobbying expenditures. A noncharity is any entity that is not described in section 501(c)(3). In order for this paragraph to apply, the electing public charity must transfer to a noncharity more in value than it receives in return. For example,

this paragraph does not apply to an electing public charity's fair market value payment of rent to a landlord. However, this paragraph does apply where an electing public charity and a noncharity share office space and the electing public charity pays more than fair market value rent to the noncharity. Similarly, this paragraph applies where an electing public charity sells goods or services to a noncharity for less than fair market value. See paragraphs (c)(3)(i) (B), (C) and (D) of this section for exceptions where non-fair market value transfers are not covered by this paragraph (c)(3). See paragraph (c)(3)(i)(E) of this section to determine the amount of any non-fair market value transfer covered by this paragraph (c)(3). See paragraph (c)(3)(ii) of this section for the rules that apply to transfers governed by this paragraph (c)(3).

(B) *Exception for controlled grants.* Notwithstanding paragraph (c)(3)(i)(A) of this section, this paragraph (c)(3) does not apply where an electing public charity makes a grant to a noncharity that is a controlled grant (as defined in § 56.4911–4(f)(3)).

(C) *Exception for transfers that artificially inflate exempt purpose expenditures.* Notwithstanding paragraph (c)(3)(i)(A) of this section, this paragraph (c)(3) does not apply where an electing public charity makes a grant to a noncharity that is an expenditure described in § 56.4911–4(e) (relating to grants that artificially inflate exempt purpose expenditures).

(D) *Exception for substantially related activity.* Notwithstanding paragraph (c)(3)(i)(A) of this section, this paragraph (c)(3) does not apply where an electing public charity, in the course of an activity that is substantially related to the accomplishment of the electing public charity's exempt purposes, makes goods or services widely available for less than fair market value to individual members of the general public and those goods or services are actually purchased (or consumed for no charge) by a substantial number of wholly unrelated individual members of the general public for less than fair market value. For purposes of the preceding sentence, the term ''individual member of the general public'' does not include any person or entity directly or indirectly affiliated with the electing public charity in question. The following example illustrates this paragraph (c)(3)(i)(D):

Example. Organization P is an educational organization dedicated to preserving the environment. One of P's activities is educating the public about the benefits of installing cost-effective passive solar energy systems, thereby helping to preserve the environment. P charges for its extensive literature and advice, but the charges are less than the fair market value of the literature and advice. P makes its literature and advice widely available to individual members of the general public by advertising in various media and by pamphlets distributed in various areas. P annually provides its literature and advice for less than fair market value to 500 wholly unrelated families, businesses, and tax-exempt organizations. Several of the businesses and tax-exempt organizations make lobbying expenditures within the meaning of section 4911. P's provision of its goods and services to these entities is not covered by this paragraph (c)(3) (and thus does not give rise to a lobbying expenditure by P under paragraph (c)(3)(ii)).

(E) *Determination of amount of transfer governed by paragraph (c)(3).* Where an electing public charity receives nothing of value in return for its transfer, the amount of the transfer governed by this paragraph (c)(3) is the greater of the fair market value or the cost of the goods or services transferred to the noncharity. Where the noncharity transfers something of value to the electing public charity in return for the charity's transfer, but that payment is less than the fair market value of the charity's transfer to the noncharity, the amount of the transfer governed by this paragraph (c)(3) is the excess of: first, the greater of the fair market value or cost of the goods or services transferred to the noncharity over, second, the value of the amount transferred to the charity. For example, if an electing public charity transfers $10,000 of goods and services to a noncharity that makes lobbying expenditures in return for payment by the noncharity of $2,000, the amount of the transfer governed by this paragraph (c)(3) is $8,000.

(ii) *Rules governing transfers to which paragraph (c)(3) applies.* A transfer to which this paragraph (c)(3) applies is treated in whole or in part as a grass

roots and/or direct lobbying expenditure by the transferor in accordance with paragraphs (c)(3)(ii) (A), (B) and (C) of this section. In applying those paragraphs, the expenditures of the transferee will be determined as if the regulations under section 4911 applied to the transferee. This paragraph (c)(3) discusses only when certain transfers are lobbying expenditures by the transferor. This paragraph does not address other issues that may arise when an electing public charity makes a noncontrolled grant to a noncharity. Nothing in this paragraph (c)(3) shall be used to interpret issues relating to noncontrolled grants by charities to noncharities, such as whether the noncontrolled grant is consistent with the continued tax-exempt status of the electing public charity.

(A) *Transfers treated as grass roots expenditures.* The transfer is treated as a grass roots expenditure to the extent of the lesser of two amounts: The amount of the transfer and the amount of the transferee's grass roots expenditures.

(B) *Transfers treated as direct lobbying expenditures.* If the transfer is greater than the transferee's grass roots expenditures, the excess is treated as a direct lobbying expenditure, but only to the extent of the transferee's direct lobbying expenditures. (If, however, the transfer is less than the transferee's grass roots expenditures, none of the transfer is a direct lobbying expenditure.)

(C) *Transfers treated as nonlobbying.* If the transfer is greater than the sum of the transferee's grass roots and direct lobbying expenditures, the excess of the transfer over those lobbying expenses is not a lobbying expenditure.

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

Example. Organization C, an electing public charity, shares employee E with N, a noncharity that makes lobbying expenditures. N's grass roots expenditures are $5,000 and its direct lobbying expenditures are $25,000. Each organization pays one-half of the $100,000 in direct and overhead costs associated with E. E devotes one-quarter of his time to C and three-quarters of his time to N. In substance, this arrangement is a transfer (for less than fair market value) from C to N in the amount of $25,000 (one-quarter of the $100,000 of direct and overhead costs associated with E's work). Accordingly, C is treated as having made a $5,000 grass roots expenditure (the lesser of N's grass roots expenditures ($5,000) or the amount of the transfer ($25,000)). C is also treated as having made a $20,000 direct lobbying expenditure (the lesser of N's direct lobbying expenditures ($25,000) or the remaining amount of the transfer ($20,000)).

§ 56.4911–4 Exempt purpose expenditures.

(a) *Application.* This section provides rules under section 4911(e) for determining an electing public charity's ''exempt purpose expenditures'' for a taxable year for purposes of section 4911(c)(2) and § 56.4911–1(c)(2). Those two sections generally define an electing public charity's lobbying limit (lobbying nontaxable amount) as a sliding scale percentage of the organization's exempt purpose expenditures. In determining an electing public charity's exempt purpose expenditures, no expenditure shall be counted twice by an organization.

(b) *Included expenditures.* Amounts paid or incurred by an organization that are exempt purpose expenditures include—

(1) Amounts paid or incurred to accomplish a purpose enumerated in section 170(c)(2)(B), including (but not limited to) the amount of any transfer made by the organization (other than a transfer described in paragraph (e) of this section) to another organization to accomplish the transferor's exempt purposes, and including amounts expended by an organization out of transfers (other than a transfer described in paragraph (e) of this section) for which the organization is the transferee,

(2) Amounts paid or incurred as current or deferred compensation for an employee's services for a purpose enumerated in section 170(c)(2)(B),

(3) The allocable portion of administrative overhead, and other general expenditures attributable to the accomplishment of a purpose enumerated in section 170(c)(2)(B),

(4) Lobbying expenditures (as defined in § 56.4911–2(a)) whether or not for a purpose enumerated in section 170(c)(2)(B),

(5) Amounts paid or incurred for activities described in § 56.4911–2(c),

(6) Amounts paid or incurred for activities described in § 56.4811–5 that are not lobbying expenditures,

(7) A reasonable allowance for exhaustion, wear and tear, obsolescence or amortization, of assets to the extent used for one or more of the purposes described in paragraphs (b)(1) through (6) of this section, computed on a straight-line basis (for this purpose, an allowance for depreciation will be treated as reasonable if based on a useful life that would satisfy section 321(k)(3)(A) as in effect on January 1, 1985), and

(8) Fundraising expenditures (but see section 4911(e)(1)(C) and paragraphs (c)(3) and (4) of this section.)

(c) *Excluded expenditures.* Notwithstanding paragraph (b) of this section, exempt purpose expenditures do not include—

(1) Amounts paid or incurred that are neither expenditures to accomplish a purpose enumerated in section 170(c)(2)(B), lobbying expenditures (as defined in § 56.4911–2(a)), nor expenditures described in paragraph (b)(5), (6) or (8) of this section,

(2) The amounts of any transfer described in paragraph (e) of this section,

(3) Amounts paid to or incurred for a separate fundraising unit (as defined in paragraph (f)(2) of this section) of an organization or of an affiliated organization (see § 56.4911–7(a)),

(4) Amounts paid to or incurred for any person not an employee, or any organization not an affiliated organization, if paid or incurred primarily for fundraising, but only if such person or organization engages in fundraising, fundraising counselling or the provision of similar advice or services,

(5) Amounts paid or incurred that are properly chargeable to a capital account, determined in accordance with the principles that apply under section 263 or, as applicable, section 263A, with respect to an unrelated trade or business,

(6) Amounts paid or incurred for a tax that is not imposed in connection with the organization's efforts to accomplish a purpose described in section 170(c)(2)(B), such as taxes imposed under sections 511(a)(1) and 4911(a), and

(7) Amounts paid or incurred for the production of income. For purposes of this section, amounts are paid or incurred for the production of income if they are paid or incurred for a purpose or activity that is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501. For example, the costs of managing an endowment are amounts that are paid or incurred for the production of income and are thus not exempt purpose expenditures. Fundraising expenditures are not, for purposes of this section, amounts that are paid or incurred for the production of income. Instead, the determination of whether fundraising costs are exempt purpose expenditures must be made with reference to section 4911(e)(1)(C) and paragraphs (b)(8), (c)(3) and (c)(4) of this section.

(d) *Certain transfers treated as exempt purpose expenditures*—(1) An organization's transfer will be treated as an exempt purpose expenditure under paragraph (b)(1) of this section if it is—

(i) Described in either paragraph (d)(2) or (d)(3) of this section, and

(ii) Not described in paragraph (e) of this section.

(2) A transfer is described in this paragraph (d)(2) if it is made to an organization described in section 501(c)(3) in furtherance of the transferor's exempt purposes and is not earmarked for any purpose other than a purpose described in section 170(c)(2)(B). Thus, a payment of dues by a local or state organization to, respectively, a state or national organization that is described in section 501(c)(3) is considered an exempt purpose expenditure of the transferor to the extent it is not otherwise earmarked.

(3) A transfer is described in this paragraph (d)(3) if it is a controlled grant (as defined in paragraph (f)(3) of this section), but only to the extent of the amounts that are paid or incurred by the transferee that would be exempt purpose expenditures if paid or incurred by the transferor.

(e) *Transfers not exempt purpose expenditures*—(1) An organization's transfer is described in this paragraph (e) if

it is described in one of paragraphs (e)(2) through (e)(4).

(2) A transfer is described in this paragraph (e)(2) if it is made to a member of any affiliated group (as defined in §56.4911–7(e)) of which the transferor is a member.

(3) A transfer is described in this paragraph (e)(3) if the Commissioner determines that the transfer artificially inflates the amount of the transferor's or transferee's exempt purpose expenditures. In general, the Commissioner will make that determination if a substantial purpose of a transfer is to inflate those exempt purpose expenditures. A transfer described in this paragraph will not be considered an exempt purpose expenditure of the transferor, but will be an exempt purpose expenditure of the transferee to the extent that the transferee expends the transfer in the active conduct of its charitable activities or attempts to influence legislation. Standards similar to those found in §53.4942(b)–1(b) may be applied in determining whether the transferee has expended amounts in the ''active conduct'' of its charitable activities or attempts to influence legislation.

(4) A transfer is described in this paragraph (e)(4) if it is not a controlled grant and is made to an organization not described in section 501(c)(3) that does not attempt to influence legislation.

(f) *Definitions*—(1) For purposes of paragraph (c) of this section, ''fundraising'' includes—

(i) Soliciting dues or contributions from members of the organization, from persons whose dues are in arrears, or from the general public,

(ii) Soliciting grants from businesses or other organizations, including organizations described in section 501(c)(3), or

(iii) Soliciting grants from a governmental unit referred to in section 170(c)(1), or any agency or instrumentality thereof.

(2) For purposes of paragraph (c) of this section, a separate fundraising unit of any organization must consist of either two or more individuals a majority of whose time is spent on fundraising for the organization, or any separate accounting unit of the organization that is devoted to fundraising. For purposes of paragraph (c) of this section, amounts paid to or incurred for a separate fundraising unit include all amounts incurred for the creation, production, copying, and distribution of the fundraising portion of a separate fundraising unit's communication. (For example, an electing public charity that has a separate fundraising unit may not count the cost of postage for a separate fundraising unit's communication as an exempt purpose expenditure even though, under the electing public charity's accounting system, that cost is attributable to the mailroom rather than to the separate fundraising unit.)

(3) For purposes of this section, a ''controlled grant'' is a grant made by an eligible organization described in §1.501(h)–2(b) to an organization not described in section 501(c)(3) that meets the following requirements:

(i) The donor limits the grant to a specific project of the recipient that is in furtherance of the donor's (nonlobbying) exempt purposes; and

(ii) The donor maintains records to establish that the grant is used in furtherance of the donor's (nonlobbying) exempt purposes.

(4) A transfer, including a grant or payment of dues, is ''earmarked'' for a specific purpose—

(i) To the extent that the transferor directs the transferee to add the amount transferred to a fund established to accomplish the purpose, or

(ii) To the extent of the amount transferred or, if less, the amount agreed upon to the expended to accomplish the purpose, if there exists an agreement, oral or written, whereby the transferor may cause the transferee to expend amounts to accomplish the purpose or whereby the transferee agrees to expend an amount to accomplish the purpose.

(g) *Example*. The provisions of this section are illustrated by the following example:

Example. Organization X is an exempt organization described in section 501(c)(3) that is organized for the purpose of rehabilitating alcoholics. X elected to be subject to the provisions of section 501(h) in 1981. For 1981, X had the following expenditures that are included in its exempt purpose expenditures to the extent indicated.

Description	Total (dollars)	Includible (dollars)
Cost of real estate purchased for use as half-way house for alcoholics, attributable to the following:		
Land	30,000	
Building	200,000	
Depreciation 40-year useful life		5,000
Expenses of operating its half-way house	170,000	170,000
Administrative expenses of the organization allocated to the operation of its half-way house	95,000	95,000
Depreciation and allowances for equipment	10,000	10,000
Expenses related to attempts to influence legislation (lobbying expenditures)	40,000	40,000
Amounts paid to Z by the Organization for fundraising	35,000	
Total	580,000	320,000

NOTE: For 1981, X's exempt purpose expenditures total $320,000. The $35,000 paid by X to Z for fundraising is not included in the exempt purpose expenditures total. All lobbying expenses are included in full. Only depreciation computed on a straight-line basis is included in exempt purpose expenditures.

§ 56.4911–5 Communications with members.

(a) *In general*. For purposes of section 4911, expenditures for certain communications between an organization and its members (''membership communications'') are treated more leniently than are communications to nonmembers. This § 56.4911–5 contains rules about the more lenient treatment. In certain cases, this section provides that expenditures for a membership communication are not lobbying expenditures even though those expenditures would be lobbying expenditures if the communication were to nonmembers. In other cases, this section provides that expenditures for a membership communication are direct lobbying expenditures even though those expenditures would be grass roots expenditures if the communication were to nonmembers. Paragraphs (b), (c) and (d) of this section set forth the more lenient rules that apply for communications that are directed only to members. Paragraph (e) of this section sets forth the more lenient rules that apply for communications that are directed primarily, but not solely, to members. Paragraph (f) of this section sets forth certain definitions and special rules.

(b) *Communications (directed only to members) that are not lobbying communications*. Expenditures for a communication that refers to, and reflects a view on, specific legislation are not lobbying expenditures if the communication satisfies the following requirements:

(1) The communication is directed only to members of the organization;

(2) The specific legislation the communication refers to, and reflects a view on, is of direct interest to the organization and its members;

(3) The communication does not directly encourage the member to engage in direct lobbying (whether individually or through the organization); and

(4) The communication does not directly encourage the member to engage in grass roots lobbying (whether individually or through the organization).

(c) *Communications (directed only to members) that are direct lobbying communications*. Expenditures for a communication that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs (b)(1), (b)(2), and (b)(4) of this section, but does not satisfy the requirements of paragraph (b)(3) of this section, are treated as expenditures for direct lobbying.

(d) *Communications (directed only to members) that are grass roots lobbying communications*. Expenditures for a communication that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs (b)(1) and (b)(2) of this section, but does not satisfy the requirements of paragraph (b)(4) of this section, are treated as grass roots expenditures (whether or not the communication satisfies the requirements of paragraph (b)(3) of this section).

(e) *Written communications directed to members and nonmembers*—(1) *In general*. Expenditures for any written communication that is designed primarily for members of an organization (but not

directed only to members) and that refers to, and reflects a view on, specific legislation of direct interest to the organization and its members, are treated as expenditures for direct or grass roots lobbying in accordance with paragraph (e)(2), (e)(3) or (e)(4) of this section. For purposes of this section, a communication is designed primarily for members of an organization if more than half of the recipients of the communication are members of the organization.

(2) *Direct lobbying directly encouraged*—(i) *Lobbying expenditure amount.* If a written communication described in paragraph (e)(1) of this section directly encourages readers to engage individually or through the organization in direct lobbying but does not directly encourage them to engage in grass roots lobbying, the cost of the communication is allocated between expenditures for direct lobbying and grass roots expenditures in accordance with paragraphs (e)(2) (ii) and (iii) of this section. The portion of the cost to be allocated includes all costs of preparing all the material with respect to which readers are urged to engage in direct lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material (see §1.512(a)–1(f)(6)).

(ii) *Grass roots amount.* The amount allocable as a grass roots expenditure for a communication described in paragraph (e)(1) of this section is the amount calculated in paragraph (e)(2)(i) of this section multiplied by the sum of the nonmember subscribers percentage and all the other distribution percentage, both as defined in paragraph (f)(7) of this section. Solely for purposes of the allocation described in this paragraph (e)(2)(ii), the nonmember subscribers percentage is treated as zero unless it is greater than 15% of total distribution.

(iii) *Direct lobbying amount.* The amount allocable as an expenditure for direct lobbying for a communication described in paragraph (e)(1) of this section is the excess of the amount described in paragraph (e)(2)(i) of this section over the amount described in paragraph (e)(2)(ii) of this section.

(3) *Grass roots expenditure if grass roots lobbying directly encouraged.* If a written communication described in paragraph (e)(1) of this section directly encourages readers to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying (whether or not it also encourages readers to engage in direct lobbying), the grass roots expenditure includes all the costs of preparing all the material with respect to which readers are urged to engage in grass roots lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material (see §1.512(a)–1(f)(6)).

(4) *No direct encouragement of direct lobbying or of grass roots lobbying.* If a written communication described in paragraph (e)(1) of this section does not directly encourage readers to engage in either direct lobbying or grass roots lobbying, expenditures for the communication are not lobbying expenditures.

(f) *Definitions and special rules.* For purposes of the regulations under section 4911—

(1) *Member; general rule.* A person is a member of an electing public charity if the person—

(i) Pays dues or makes a contribution of more than a nominal amount,

(ii) Makes a contribution of more than a nominal amount of time, or

(iii) Is one of a limited number of ''honorary'' or ''life'' members who have more than a nominal connection with the electing public charity and who have been chosen for a valid reason (such as length of service to the organization or involvement in activities forming the basis of the electing public charity's exemption) unrelated to the electing public charity's dissemination of information to its members.

(2) *Member; special rule.* A person not a member of an electing public charity within the meaning of paragraph (f)(1) of this section may be treated as a member if the electing public charity demonstrates to the satisfaction of the Internal Revenue Service that there is a good reason for its membership requirements not meeting the requirements of such paragraph (f)(1), and that its membership requirements do not operate to permit an abuse of the rules described in this section.

(3) *Member; affiliated group of organizations.* For purposes of this section, a

person who is a member of an organization that is a member of an affiliated group of organizations (within the meaning of § 56.4911–7(e)) is treated as a member of each organization in the affiliated group.

(4) *Member; limited affiliated group of organizations.* For purposes of this section, a person who is a member of an organization that is a member of a limited affiliated group of organizations (within the meaning of § 56.4911–10(b)) is treated as a member of each organization in the limited affiliated group, but only to the extent that the communication relates to a national legislative issue (within the meaning of § 56.4911–10(g)).

(5) *Subscriber.* A person is a subscriber to a written communication if—

(i) The person is a member of the publishing organization and the membership dues expressly include the right to receive the written communication, or

(ii) The person has affirmatively expressed a desire to receive the written communication and has paid more than a nominal amount of the communication.

(6) Directly encourages—(i) *Direct lobbying*—(A) *In general.* For purposes of this section, a communication directly encourages a recipient to engage in direct lobbying, whether individually or through the organization, if the communication:

(*1*) States that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(*2*) States the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(*3*) Provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation).

(B) *''Self-defense'' exception for communications with members.* Notwithstanding the provisions of paragraph (f)(6)(i)(A) of this section, for purposes of paragraphs (b)(3), (e)(2)(i), (e)(3) and (e)(4) of this section, a communication that directly encourages a member to engage in direct lobbying activities that are described in section 4911(d)(2)(C) and that would not be attempts to influence legislation if engaged in directly by the organization is treated as a communication that does not directly encourage a member to engage in direct lobbying.

(ii) *Grass roots lobbying.* For purposes of paragraphs (b)(4), (e)(3) and (e)(4) of this section, a communication directly encourages recipients to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying if the communication:

(A) States that the recipient should encourage any nonmember to contact a legislator or an employee of a legislative body, or to contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(B) States that the recipient should provide to any nonmember the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) Provides (or requests that the recipient provide to nonmembers) a petition, tear-off postcard or similar material for the recipient (or nonmember) to use to ask any nonmember to communicate views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation, but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation. For purposes of this paragraph (f)(6)(ii)(C), a petition is provided for the recipient to use to ask any nonmember to communicate views if, for example, the petition has an entire page of preprinted signature blocks.

Similarly, for purposes of this paragraph (f)(6)(ii)(C), where a communication is distributed to a single member and provides several tear-off postcards addressed to a legislator, the postcards are presumed to be provided for the member to use to ask a nonmember to communicate with the legislator.

(7) *Percentages of total distribution.* With respect to a communication described in paragraph (e)(1) of this section—

(i) ''*Member percentage*'' means the percentage of total distribution that represents distribution of a single copy to any member;

(ii) ''*Nonmember subscribers percentage*'' means the percentage of total distribution that represents distribution to nonmember subscribers (including libraries); and

(iii) ''*All other distribution percentage*'' means 100% reduced by the sum of the member percentage and the nonmember subscribers percentage.

(8) *Reasonable allocation rule.* In the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an electing public charity must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. See § 56.4911–3(a)(2)(ii).

§ 56.4911–6 Records of lobbying and grass roots expenditures.

(a) *Records of lobbying expenditures.* An electing public charity must keep a record of its lobbying expenditures for the taxable year. Lobbying expenditures of which an organization must keep a record include the following:

(1) Expenditures for grass roots lobbying, as described in paragraph (b) of this section;

(2) Amounts directly paid or incurred for direct lobbying, including payments to another organization earmarked for direct lobbying, fees and expenses paid to individuals or organizations for direct lobbying, and printing, mailing, and other direct costs of reproducing and distributing materials used in direct lobbying;

(3) The portion of amounts paid or incurred as current or deferred compensation for an employee's services for direct lobbying;

(4) Amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for direct lobbying, whether or not incurred by an employee;

(5) The allocable portion of administrative, overhead, and other general expenditures attributable to direct lobbying;

(6) Expenditures for publications or for communications with members to the extent the expenditures are treated as expenditures for direct lobbying under § 56.4911–5; and

(7) Expenditures for direct lobbying of a controlled organization (within the meaning of § 56.4911–10(c)) to the extent included by a controlling organization (within the meaning of § 56.4911–10(c)) in its lobbying expenditures.

(b) *Records of grass roots expenditures.* An electing public charity must keep a record of its grass roots expenditures for the taxable year. Grass roots expenditures of which an organization must keep a record include the following:

(1) Amounts directly paid or incurred for grass roots lobbying, including payments to other organizations earmarked for grass roots lobbying, fees and expenses paid to individuals or organizations for grass roots lobbying, and the printing, mailing, and other direct costs of reproducing and distributing materials used in grass roots lobbying;

(2) The portion of amounts paid or incurred as current or deferred compensation for an employee's services for grass roots lobbying;

(3) Amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for grass roots lobbying, whether or not incurred by an employee;

(4) The allocable portion of administrative, overhead and other general expenditures attributable to grass roots lobbying;

(5) Expenditures for publication or communications that are treated as expenditures for grass roots lobbying under § 56.4911–5; and

(6) Expenditures for grass roots lobbying of a controlled organization (within the meaning of § 56.4911–10(c))

to the extent included by a controlling organization (within the meaning of § 56.4911–10(c)) in its grass roots expenditures.

§ 56.4911–7 Affiliated group of organizations.

(a) *Affiliation between two organizations.* Sections 4911(f) (1) through (3) contain a limited anti-abuse rule for groups of affiliated organizations. In general, the rule operates to prevent numerous organizations from being created for the purpose of avoiding the sliding-scale percentage limitation on an electing public charity's lobbying expenditures (as well as avoiding the $1,000,000 cap on a single electing public charity's lobbying expenditures). This is generally accomplished by treating the members of an affiliated group as a single organization for purposes of measuring both lobbying expenditures and permitted lobbying expenditures. The anti-abuse rule is implemented by this § 56.4911–7 and §§ 56.4911–8 and 56.4911–9. This § 56.4911–7 defines the term ''affiliated group of organizations'' and defines the taxable year of an affiliated group of organizations. Section 56.4911–8 provides rules concerning the exempt purpose expenditures, lobbying expenditures and grass roots expenditures of an affiliated group of organizations, as well as rules concerning the application of the excise tax imposed by section 4911(a) on excess lobbying expenditures by the group. Section 56.4911–9 provides rules concerning the application of the section 501(h) lobbying expenditure limits to members of an affiliated group of organizations. (For additional rules for members of a limited affiliated group of organizations (generally, organizations that are affiliated solely by reason of governing instrument provisions that extend control solely with respect to national legislation), see section 4911(f)(4) and § 56.4911–10).

(1) *In general.* For purposes of the regulations under section 4911, two organizations are affiliated, subject to the limitation described in paragraph (a)(2) of this section, if one organization is able to control action on legislative issues by the other by reason of interlocking governing boards (see paragraph (b) of this section) or by reason of provisions of the governing instruments of the controlled organization (see paragraph (c) of this section). The ability of the controlling organization to control action on legislative issues by the controlled organization is sufficient to establish that the organizations are affiliated; it is not necessary that the control be exercised.

(2) *Organizations not described in section 501(c)(3).* Two organizations, neither of which is described in section 501(c)(3), are affiliated only if there exists at least one organization described in section 501(c)(3) that is affiliated with both organizations.

(3) *Action on legislative issues.* For purposes of this section, the term ''action on legislative issues'' includes taking a position in the organization's name on legislation, authorizing any person to take a position in the organization's name on legislation, or authorizing any lobbying expenditures. The phrase does not include actions taken merely to correct unauthorized actions taken in the organization's name.

(b) *Interlocking governing boards*—(1) *In general.* Two organizations have interlocking governing boards if one organization (the controlling organization) has a sufficient number of representatives (within the meaning of paragraph (b)(5) of this section) on the governing board of the second organization (the controlled organization) so that by aggregating their votes, the representatives of the controlling organization can cause or prevent action on legislative issues by the controlled organization. If two organizations have interlocking governing boards, the organizations are affiliated without regard to how or whether the representatives of the controlling organization vote on any particular matter.

(2) *Majority or quorum.* Except as provided in paragraph (b) (3) or (4) of this section, the number of representatives of an organization (the controlling organization) who are members of the governing board of a second organization (the controlled organization) will be presumed sufficient to cause or prevent action on legislative issues by the controlled organization if that number either—

(i) Constitutes a majority of incumbents on the governing board, or

(ii) Constitutes a quorum, or is sufficient to prevent a quorum, for acting on legislative issues.

(3) *Votes required under governing instrument or local law.* Except as provided in paragraph (b)(4) of this section, if under the governing documents of an organization (the controlled organization), it can be determined that a lesser number of votes than the number described in paragraph (b)(2) of this section is necessary or sufficient to cause or to prevent action on legislative issues, the number of representatives of the controlling organization who are members of the governing board of the controlled organization will be considered sufficient to cause or prevent action on legislative issues if it equals or exceeds that number.

(4) *Representatives constituting less than 15% of governing board.* Notwithstanding paragraph (b) (2) or (3) of this section, if the number of representatives of one organization is less than 15 percent of the incumbents on the governing board of a second organization, the two organizations are not affiliated by reason of interlocking governing boards.

(5) *Representatives.* (i) This paragraph (b)(5) describes members of the governing board of one organization (the controlled organization) who are considered representatives of a second organization (the controlling organization). Under this paragraph (b)(5), a member of the governing board of a controlled organization may be a representative of more than one controlling organization. A person with no authority to vote on any issue being considered by the governing board is not a representative of any organization.

(ii) A board member of one organization (the controlled organization) is a representative of a second organization (the controlling organization) if the controlling organization has specifically designated that person to be a board member of the controlled organization. For purposes of this paragraph (b)(5)(ii) and paragraph (b)(5)(iii) of this section, a board member of the controlled organization is specifically designated by the controlling organization if the board member is selected by virtue of the right of the controlling organization, under the governing instruments of the controlled organization, either to designate a person to be a member of the controlled organization's governing board, or to select a person for a position that entitles the holder of that position to be a member of the controlled organization's governing board.

(iii) A board member of one organization who is specifically designated by a second organization, a majority of the governing board of which is made up of representatives of a third organization, is a representative of the third organization as well as being a representative of the second organization pursuant to paragraph (b)(5)(ii) of this section.

(iv) A board member of one organization who is also a member of the governing board of a second organization is a representative of the second organization.

(v) A board member of one organization who is an officer or paid executive staff member of a second organization is a representative of the second organization. Although titles are significant in determining whether a person is a member of the executive staff of an organization, any employee of an organization who possesses authority commonly exercised by an executive is considered an executive staff member for purposes of this paragraph (b)(5)(v).

(c) *Governing instrument.* One organization (the ''controlling'' organization) is affiliated with a second organization (the ''controlled'' organization) by reason of the governing instruments of the contolled organization if the governing instruments of the controlled organization limit the independent action of the controlled organization on legislative issues by requiring it to be bound by decisions of the other organization on legislative issues.

(d) *Three or more organizations affiliated*—(1) *Two controlled organizations affiliated.* If a controlling organization described in this section is affiliated with each of two or more controlled organizations described in this section, then the controlled organizations are affiliated with each other.

(2) *Chain rule.* If one organization is a controlling organization described in this section with respect to a second organization and that second organization is a controlling organization with

respect to a third organization, then the first organization is affiliated with the third.

(e) *Affiliated group of organizations*—(1) *Defined*. For purposes of the regulations under section 4911, an affiliated group of organizations is a group of organizations—

(i) Each of which is affiliated with every other member for at least thirty days of the taxable year of the affiliated group (determined without regard to the election provided for in paragraph (e)(5) of this section),

(ii) Each of which is an eligible organization (within the meaning of § 1.501(h)–2(b)(1)), and

(iii) At least one of which is an electing member organization (within the meaning of paragraph (e)(4) of this section).

Each organization in a group of organizations that satisfies the requirements of the preceding sentence is a member of the affiliated group of organizations for the taxable year of the affiliated group.

(2) *Multiple membership*. For any taxable year of an organization, it may be a member of two or more affiliated groups of organizations.

(3) *Taxable year of affiliated group*. If all members of an affiliated group have the same taxable year, that taxable year is the taxable year of the affiliated group. If the members of an affiliated group do not all have the same taxable year, the taxable year of the affiliated group is the calendar year, unless the election under paragraph (e)(5) of this section is made.

(4) *Electing member organization*. For purposes of the regulations under section 4911, an ''electing member organization'' is an organization to which the expenditure test election under section 501(h) applies on at least one day of the taxable year of the affiliated group of which it is a member. For purposes of the preceding sentence (and notwithstanding § 1.501(h)–2(a)), the expenditure test is not considered to apply to the organization on any day before the date on which it files the Form 5768 making the expenditure test election.

(5) *Election of member's year as group's taxable year*. The taxable year of an affiliated group may be determined according to the provisions of this paragraph (e)(5) if all of the members of the affiliated group so elect. Under this paragraph (e)(5), each member organization shall apply the provisions of section 501(h) and 4911, and the regulations thereunder (unless the regulations provide otherwise), by treating its own taxable year as the taxable year of the affiliated group. The election may be made by an electing member organization by attaching to its annual return a statement from itself and every other member of the affiliated group that contains: the organization's name, address, and employer identification number; and its signed consent to the election provided for in this paragraph (e)(5). The election must be made no later than the due date of the first annual return of any electing member for its taxable year for which the member is liable for tax under section 4911(a), determined under § 56.4911–8(d). The election may not be made or revoked after the due date of the return referred to in the preceding sentence except upon such terms and conditions as the Commissioner may prescribe.

(f) *Examples*. The provisions of this section are illustrated by the following examples.

Example 1. M, N, and O are eligible organizations within the meaning of § 1.501(h)–2(b)(1). Each has a governing board made up of nine members. Five members on the board of N are also members of the board of M. N designates five individuals from among its board, officers, and executive staff members to serve on the board of O. M is affiliated with N, N is affiliated with O, and M is affiliated with O.

Example 2. X, an eligible organization, has a board consisting of 10 members. Five unaffiliated tax-exempt organizations each designate two individuals to serve on the governing board of X. A simple majority of the board of X is a quorum and may establish X's position on legislative issues. X is not affiliated with any of the five autonomous organizations by reason of interlocking governing boards.

Example 3. P and Q are eligible organizations. The governing instruments of Q state that it will not take a position on legislation if P disapproves of the position. In addition, there is regular correspondence between P and Q with regard to positions on legislation. P is affiliated with Q regardless of whether P has ever vetoed a position taken by Q.

Example 4. The governing board of organization R resolves to adopt the position taken on legislative issues by organization S. R

and S are eligible organizations and do not have interlocking governing boards. The governing instruments of R do not mention organization S and do not indicate that R is to be bound by the decisions of legislation of any organization. R and S are not affiliated.

Example 5. Organization Z is bound, under the terms of its governing instruments, by the legislative positions of Organization Y. Organization Y, however, is bound, under the terms of its governing instruments, by the legislative positions of Organization X. Organization X is affiliated with Y and Z; Y is affiliated with X and Z; and Z is affiliated with X and Y.

Example 6. Organizations T and U have interlocking boards of directors. T is the controlling organization. Organization V is bound, under the terms of its governing instruments, by the legislative positions of U. T and V are affiliated because T may cause or prevent action on legislative issues by U, and V is bound by U's action. If U were the controlling organization, T and V would be affiliated as two organizations controlled by the same organization.

Example 7. Organization A is described in section 501(c)(4). It is affiliated, as the controlling organization, with organizations K and L, both of which are described in section 501(c)(3) and are eligible to elect under section 501(h). If K elects under section 501(h), K and L are an affiliated group of organizations. Even though A is affiliated with K and L, A is not a member of that affiliated group of organizations because A is not an eligible organization within the meaning of § 1.501(h)–2(b)(1) (see § 56.4911–7(e)(1) for the definition of which affiliated organizations may be members of an affiliated group of organizations).

Example 8. G, H, I, and J are eligible organizations. G, H, and I have elected the expenditure test under section 501(h). The governing board of J has nine members. Under the governing instruments of J, organizations G, H, and I each designate three members of the governing board of J. Also under the governing instruments of J, action on legislative issues requires the approval of any seven board members. Because the three representatives of G may prevent action on legislative issues, J is affiliated with G. Similarly, J is affiliated with each of H and I. However, under none of the rules of affiliation is G affiliated with H, or H with I, or I with G. Therefore J is a member of one affiliated group comprising G and J, of another group comprising H and J, and of a third group comprising I and J.

Example 9. Organizations C, D, and E have been affiliated for many years and have all elected the expenditure test. Each has a taxable year ending July 31. For every day of the year ending July 31, 1992, they were eligible organizations, electing member organizations, and affiliated with each other. On no day of that year were they affiliated with any other eligible organization having a different taxable year. Therefore, the year ending July 31, 1992, is the taxable year of the affiliated group comprising C, D, and E.

§ 56.4911–8 Excess lobbying expenditures of affiliated group.

(a) *Application*. This section provides rules concerning the exempt purpose expenditures, lobbying expenditures, and grass roots expenditures of an affiliated group of organizations, and the application of the excise tax imposed by section 4911(a) on the excess lobbying expenditures of the group.

(b) *Affiliated group treated as one organization*. Under section 4911(f), an affiliated group of organizations is treated as a single organization for purposes of the tax imposed by section 4911(a). For any taxable year of the affiliated group, the group's lobbying expenditures, grass roots expenditures, and exempt purpose expenditures are equal to the sum of the lobbying expenditures, grass roots expenditures, and exempt purpose expenditures, respectively, paid or incurred by each member during the taxable year of the affiliated group. The lobbying and grass roots nontaxable amounts for the affiliated group for a taxable year are determined under section 4911(c) (2) and (4) and § 56.4911–1(c) and are based on the sum of the exempt purpose expenditures described in the preceding sentence. The lobbying and grass roots ceiling amounts for the affiliated group for a taxable year are calculated under § 1.501(h)–3(c) (3) and (6) based upon the nontaxable amounts determined pursuant to the preceding sentence.

(c) *Tax imposed on excess lobbying expenditures of affiliated group*. The excise tax under section 4911(a) is imposed for a taxable year of an affiliated group if the group has excess lobbying expenditures. For any taxable year of an affiliated group, the group's excess lobbying expenditures are the greater of—

(1) The amount by which the group's lobbying expenditures exceed the group's lobbying nontaxable amount, or

(2) The amount by which the group's grass roots expenditures exceed the group's grass roots nontaxable amount.

(d) *Liability for tax*—(1) *Electing organizations*. As provided in this paragraph

(d), an electing member organization is liable for all or a portion of the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations. An organization that is liable under this paragraph (d) is not liable for any excise tax under section 4911 based on its own excess lobbying expenditures. A member of the affiliated group that is not an electing member organization is not liable for any portion of the excise tax that is imposed with respect to the affiliated group.

(2) *Tax based on excess lobbying expenditures.* If the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is based upon the amount described in paragraph (c)(1) of this section, and at least one electing member has made lobbying expenditures, each electing member organization is liable for a portion of the tax equal to the amount of the tax multiplied by a fraction, the numerator of which is the electing member organization's lobbying expenditures paid or incurred during the taxable year of the affiliated group, and the denominator of which is the sum of the lobbying expenditures of all electing member organizations in the group paid or incurred during the taxable year of the affiliated group.

(3) *Tax based on excess grass roots expenditures.* If the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is based upon the amount described in paragraph (c)(2) of this section, and at least one electing member has made grass roots expenditures, each electing member organization is liable for a portion of the tax equal to the amount of the tax multiplied by the fraction described in paragraph (d)(2) of this section, except that ''grass roots expenditures'' is substituted for ''lobbying expenditures.''

(4) *Tax based on exempt purpose expenditures.* If the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is based upon the amount described in paragraph (c)(2) of this section, and if paragraphs (d)(2) and (d)(3) of this section do not apply because no electing organization has made lobbying or grass roots expenditures, respectively, each electing member organization is liable for a portion of the tax equal to the amount of tax multiplied by a fraction the numerator of which is the electing member organization's exempt purpose expenditures and the denominator of which is the exempt purpose expenditures of all the electing member organizations in the affiliated group.

(5) *Taxable year for which liable.* An electing member organization that is liable for all or a portion of the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is liable for the tax as if the tax were imposed for its taxable year with which or within which ends the taxable year of the affiliated group.

(6) *Organization a member of more than one affiliated group.* If, under this paragraph (d), an organization is liable for its taxable year for two or more excise taxes imposed by section 4911(a) on the excess lobbying expenditures of two or more affiliated groups, then the organization is liable only for the greater of the two or more taxes.

(e) *Former member organization.* An electing member organization that ceases to be a member of an affiliated group of organizations, the taxable year of which is different from its own, must thereafter determine its liability under § 56.4911–1 for the excise tax imposed by section 4911(a) as if its taxable year were the taxable year of the affiliated group of which it was formerly a member. An organization to which this paragraph (e) applies that is liable for the excise tax imposed by section 4911(a) is liable for the tax as if the tax were imposed for its taxable year within which ends the taxable year of the affiliated group of which it was formerly a member. The Commissioner may, at the Commissioner's discretion, permit an organization to disregard the rules of this paragraph (e) and to determine any liability under section 4911(a) based upon its own taxable year.

§ 56.4911–9 Application of section 501(h) to affiliated groups of organizations.

(a) *Scope*. This section provides rules concerning the application of the limitations of section 501(h) to members of an affiliated group of organizations (as defined in § 56.4911–7(e)(1)).

(b) *Determination required*. For each taxable year of an affiliated group of organizations, the calculations described in § 1.501(h)–3(b)(1) (i) and (ii) must be made, based on the expenditures of the group. If, for a taxable year of an affiliated group, it is determined that the sum of the affiliated group's lobbying or grass roots expenditures for the group's base years exceeds 150 percent of the sum of the group's corresponding nontaxable amounts for the base years, then under section 501(h), each member organization that is an electing member organization (as defined in § 56.4911–7(e)(4)) at any time in the taxable year of the affiliated group shall be denied tax exemption beginning with its first taxable year beginning after the end of such taxable year of the affiliated group. Thereafter, exemption shall be denied unless (pursuant to § 1.501(h)–3(d)) the organization reapplies and is recognized as exempt as an organization described in section 501(c)(3). For purposes of this section, the term *base years* generally means the taxable year of the affiliated group for which a determination is made and the group's three preceding taxable years. Base years, however, do not include any year preceding the first year in which at least one member of the group was treated as described in section 501(c)(3).

(c) *Member organizations that are not electing organizations*. An organization that is a member of an affiliated group of organizations but that is not an electing member organization remains subject to the ''substantial part test'' described in section 501(c)(3) with respect to its activities involving attempts to influence legislation.

(d) *Filing of information relating to affiliated group of organizations*—(1) *Scope*. The filing requirements described in this paragraph (d) apply to each member of an affiliated group or organizations for the taxable year of the member with which, or within which, ends the taxable year of the affiliated group.

(2) *In general*. Each member of an affiliated group of organizations shall provide to every other member of the group, before the first day of the second month following the close of the affiliated group's taxable year, its name, identification number, and the information required under § 1.6033–2(a)(2)(ii)(*k*) for its expenditures during the group's taxable year and for prior taxable years of the group that are base years under paragraph (b). For groups electing under § 56.4911–7(e)(5) to have each member file information with respect to the group based on its taxable year, each member shall provide the information required by the preceding sentence by treating each taxable year of any member of the group as a taxable year for the group.

(3) *Additional information required*. In addition to the information required by § 1.6033–2(a)(2)(ii)(*k*), each member of an affiliated group of organizations must provide on its annual return the group's taxable year and, if the election under § 56.4911–7(e)(5) is made, the name, identification number, and taxable year identifying the return with which its consent to the election was filed.

(4) *Information required of electing member organization*. In addition to the information required by § 1.6033–2(a)(2)(ii)(*k*) and paragraph (d)(3) of this section, each electing member organization (as defined in § 56.4911–7(e)(4)) must provide on its annual return—

(i) The name and identification number of each member of the group, and

(ii) The appropriate calculation described in § 56.4911–8(d), if the organization is an electing member organization liable for all or any portion of the excise tax imposed by section 4911(a).

(e) *Example*. The provisions of this section may be illustrated by the following example:

Example. (1) M, N, and O are affiliated organizations under § 56.4911–7(a). M's taxable year ends November 30, N's, January 31, and O's, June 30. On June 20, 1979, O files Form 5768 to elect to be governed by the expenditure test. M files Form 5768 in December of 1979. Neither M nor O revokes the election, and no organization makes the election provided for in § 56.4911–7(e)(5). M, N, and O constitute an affiliated group of organizations,

the first taxable year of which is the calendar year 1979.

(2) Because the organizations did not elect under § 56.4911–7(e)(5) to use their own taxable years as the group's taxable years, the expenditures of the affiliated group for its first taxable year are the expenditures made by M, N, and O during calendar year 1979, and are reported by M, N, and O on their returns for their taxable years within which falls December 31, 1979. M reports the expenditures of the affiliated group for 1979 on its return for its taxable year ending November 30, 1980; and O, on its return for its taxable year ending June 30, 1980. N is not an electing member (as defined in § 56.4911–7(e)(4)). Accordingly, under paragraph (d)(3)(i) of this section, it reports the name and identification number of each member of the group.

(3) The following tables summarize the expenditures by the affiliated group for the calendar years indicated. None of the group's lobbying expenditures for its taxable years 1979 through 1982 were grass roots expenditures.

TABLE I—GROUP'S EXPENDITURES

Year	Exempt purpose expenditures (EPE)	Calculation	Lobbying nontaxable amount (LNTA)	Lobbying expenditures (LE)
1979	$400,000	(20%×$400,000=)	$80,000	$100,000
1980	300,000	(20%×$300,000=)	60,000	100,000
1981	600,000	(20%×$500,000+ 15%×$100,000=)	115,000	120,000
1982	500,000	(20%×$500,000=)	100,000	220,000
Total	1,800,000		355,000	540,000

TABLE II—EXPENDITURES OF M AND O

	Exempt purpose expenditures		Lobbying nontaxable amount		Lobbying expenditures		M plus O
	M	O	M	O	M	O	
1979	125,000	100,000	25,000	20,000	60,000	20,000	80,000
1980	100,000	50,000	20,000	10,000	40,000	40,000	80,000
1981	250,000	100,000	50,000	20,000	60,000	40,000	100,000
1982	200,000	100,000	40,000	20,000	160,000	40,000	200,000

(4) For the affiliated group's taxable years 1979, 1980, 1981, and 1982, the group has excess lobbying expenditures. Under section 4911(f)(1)(B) and § 56.4911–8(d), M and O, as electing member organizations, are liable for a portion of the 25 percent excise tax imposed on the group's excess lobbying expenditures, based on their respective shares of the lobbying expenditures of all electing member organizations. For 1979, the excess lobbying expenditures are $20,000 ($100,000 − $80,000). The tax is 25% of $20,000 or $5,000; M must pay $3,750 (($60,000/$80,000) × $5,000 = $3,750), and O must pay $1,250 (($20,000/$80,000) × $5,000 = $1,250). For 1980, the tax is $10,000 and each must pay $5,000. For 1981, the tax is $1,250, of which M must pay $750 and O must pay $500. For 1982, the tax is $30,000. M must pay $24,000 and O must pay $6,000. M and O are not liable for any separate 4911 excise tax that otherwise would have been imposed on their separate excess lobbying expenditures.

(5) Under § 56.4911–9(b), the group must make the calculation described in § 1.501(h)–3(b)(1) for each of the group's taxable years 1979 through 1982. The following illustrates only the required calculation for the group's taxable year 1982. For its taxable year 1982, the group must determine whether it normally has made lobbying expenditures in excess of its lobbying ceiling amount. The determination takes into account the group's expenditures in base years 1979 through 1982. The sum of the group's lobbying expenditures for the base years ($540,000) exceeds 150% of the sum of the group's lobbying nontaxable amounts for the base years (150% × $355,000 = $532,500). Therefore, for its taxable year 1982, the group normally has made lobbying expenditures in excess of its lobbying ceiling amount. Under section 501(h) and § 56.4911–9(b), M is not exempt from tax under section 501(a) as an organization described in section 501(c)(3) for its taxable year beginning December 1, 1983, and O is not exempt for its year beginning July 1, 1983. Whether N's lobbying expenditures disqualify it for tax exemption at any time after January 1, 1979, is determined under the substantial part test of section 501(c)(3).

(f) *Cross reference*. For other provisions relating to members of an affiliated group or organizations, see §§ 56.4911–2(c)(4)(ii), 56.4911–4(c)(2), 56.4911–4(e), and 56.4911–5(f)(3).

§ 56.4911–10 Members of a limited affiliated group of organizations.

(a) *Scope*. This section provides additional rules for members of a limited affiliated group of organizations, as defined in paragraph (b) of this section (relating generally to organizations that are affiliated solely by reason of provisions of their governing instruments that extend control solely with respect to national legislation). Except as otherwise provided in this section, §§ 56.4911–8 and 56.4911–9 do not apply to members of a limited affiliated group. Thus, as modified by this section, the regulations under sections 501(h) and 4911 apply to electing members of a limited affiliated group individually. For example, §§ 56.4911–2 through 56.4911–4, which, by their terms, include amounts described in paragraph (d) of this section, are used in applying sections 501(h) and 4911 to controlling member organizations (within the meaning of paragraph (c) of this section). Except as otherwise provided in this section, members of a limited affiliated group that are not electing organizations are subject to the substantial part test.

(b) *Members of limited affiliated group*. For purposes of section 4911, a limited affiliated group consists of two or more organizations that meet the following requirements:

(1) Each organization is a member of an affiliated group of organizations as defined in § 56.4911–7(e);

(2) No two members of the affiliated group described in paragraph (b)(1) of this section are affiliated by reason of interlocking governing boards under § 56.4911–7(b); and

(3) No member of the affiliated group described in paragraph (b)(1) of this section is, under its governing instrument, bound by decisions of one or more of the other such members on legislative issues other than national legislative issues.

Each organization in a group of organizations that satisfies the requirements of the preceding sentence is a member of the limited affiliated group.

(c) *Controlling and controlled organizations*. For purposes of this section, a member of a limited affiliated group is a controlling member organization if it controls one or more of the other members of the limited affiliated group, and a member of a limited affiliated group is a controlled member organization if it is controlled by one or more of the other members of the limited affiliated group. For purposes of the preceding sentence, whether an organization controls a second organization shall be determined by whether the second organization is bound, under its governing instruments, by actions taken by the first organization on national legislative issues.

(d) *Expenditures of controlling organization*—(1) *Scope*. This paragraph (d) applies to a controlling member organization that has the expenditure test election in effect for its taxable year. This paragraph (d) applies whether or not the organization is also a controlled member organization. In determining a controlling member organization's expenditures, no expenditure shall be counted twice.

(2) *Expenditures for direct lobbying*. A controlling member organization for which the expenditure test election is in effect shall include in its direct lobbying expenditures for its taxable year the direct lobbying expenditures (as defined in §§ 56.4911–2 and 56.4911–3) paid or incurred with respect to national legislative issues during such year by each organization that is a member of the limited affiliated group and is controlled (within the meaning of paragraph (c) of this section) by such controlling member organization.

(3) *Grass roots expenditures*. A controlling member organization for which the expenditure test election is in effect shall include in its grass roots expenditures for its taxable year the grass roots expenditures (as defined in §§ 56.4911–2 and 56.4911–3) paid or incurred with respect to national legislative issues during such year by each organization that is a member of the limited affiliated group and is controlled (within the meaning of paragraph (c) of this section) by such controlling member organization.

(4) *Exempt purpose expenditures*. The exempt purpose expenditures of a controlling member organization do not include the exempt purpose expenditures (other than lobbying expenditures described in paragraphs (d)(2) and (d)(3) of this section) of any organization that is a controlled member organization with respect to it.

(e) *Expenditures of controlled member*. A controlled member organization that is an electing organization but that does not control (within the meaning of paragraph (c) of this section) any organization in the limited affiliated group shall apply sections 501(h) and 4911 and the regulations thereunder without regard to the expenditures of any other member of the limited affiliated group.

(f) *Reports of members of limited affiliated groups*—(1) *Controlling member organization's additional information on annual return*. In addition to the information required by § 1.6033–2(a)(2)(ii)(*k*), each controlling member organization for which the expenditure test election is in effect must provide on its annual return the name and identification number of each member of the limited affiliated group.

(2) *Reports of controlling members to other members*. Each controlling member organization for which an expenditure test election is in effect must notify each member that it controls of its taxable year in order for the controlled organization to prepare the report required by paragraph (f)(3) of this section. Such notification must be made before the beginning of the second month after the close of each taxable year of the controlling member for which the election is in effect.

(3) *Reports of controlled member organization*. Every controlled member organization (whether or not the expenditure test election is in effect with respect to it) shall provide to each member of the limited affiliated group that controls it, before the first day of the second month following the close of the taxable year of each such controlling organization, its name, identification number, and the lobbying expenditures and grass roots expenditures on national legislative issues incurred by the controlled member organization.

(g) *National legislative issues*. The term ''national legislative issue'' means legislation, limited to action by the Congress of the United States or by the public in any national procedure. If an issue is both national and local, it is characterized as a national legislative issue if the contemplated legislation is Congressional legislation.

(h) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. State X has an income tax law that uses definitions contained in the Internal Revenue Code as it may be amended from time to time. Legislation to change a definition in the Internal Revenue Code is pending in Congress. This is a national legislative issue even though Congressional action may affect state law.

Example 2. Organization M takes a position favoring approval by Congress of a proposed amendment to the United States Constitution. This is a national legislative issue. After approval by Congress and submission to the states for ratification, the proposed amendment ceases to be a national legislative issue.

Example 3. N, O, and P are organizations described in section 501(c)(3) that do not have interlocking governing boards, within the meaning of § 56.4911–7(b). N has elected the expenditure test under section 501(h). By virtue of the governing instruments of O and P, any decision made by N on national legislative issues (such as issues concerning action on acts, bills, resolutions, or similar items by Congress) binds both O and P. Under their governing instruments, O and P are not bound on any other issues. Therefore, N, O, and P constitute a limited affiliated group. If P sends a series of letters and pamphlets to members of Congress in support of bill V, their cost will be included in N's and P's expenditures for direct lobbying and in N's and P's exempt purposes expenditures, but will not be included in O's lobbying expenditures. If N hires a lobbyist to solicit support for bill V, the cost of hiring the lobbyist will be includable only in N's lobbying expenditures. Any lobbying expenditures incurred by either O or P on any issue that is not a national legislative issue will not be included in N's lobbying expenditures.

Example 4. Y is an electing organization and a member of a limited affiliated group of organizations. Y controls organizations A, B, and C with respect to national legislative issues but is not controlled by any other organization.—Y's taxable year is the calendar year. During 1982, A dissolves on March 15th and D, also controlled by Y with respect to national legislative issues, is established on May 1st. For 1982 the limited affiliated group comprises Y, A, B, C, and D.

Example 5. P, Q, R, and S are electing organizations. The governing instruments of Q require it to adopt the positions on national legislative issues adopted by P. R is similarly bound by Q's positions. R and S have interlocking governing boards, within the meaning of § 56.4911–7(b), but S's governing instruments do not require it to adopt the position of any other organization on any legislative issues. Under § 56.4911–7(e)(1), P, Q, R, and S are members of an affiliated group. Applying paragraph (b) of this section, it is determined that (1) P, Q, R and S are members of an affiliated group; and (2) R and S are affiliated by reason of interlocking governing boards. Accordingly, P, Q, R and S are not a limited affiliated group. Similarly, P, Q, and R do not constitute a limited affiliated group because they are members of an affiliated group comprising P, Q, R, and S, two of whose members, R and S, are affiliated by reason of interlocking governing boards.

Example 6. T, U, V, and W are electing organizations. The governing instruments of U and V require them to adopt the positions on national legislative issues adopted by T, but do not require them to adopt the positions of any organization on any other legislative issues. The governing documents of W require it to adopt the positions of V on all legislative issues. Applying paragraph (b) of this section, it is determined that (1) T, U, V, and W are all members of an affiliated group; (2) no two of T, U, V, and W are affiliated by reason of interlocking governing boards; but (3) W is bound, under its governing instrument, by decisions of V on legislative issues that are not national legislative issues. Accordingly, T, U, V, and W do not constitute a limited affiliated group. Similarly, T, U, and V do not constitute a limited affiliated group. T, U, V, and W are an affiliated group under § 56.4911–7.

§ 56.6001–1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* The provisions of § 53.6001–1 shall apply to any person subject to tax under chapter 41, subtitle D, of the Code, by treating each reference to chapter 42 in § 53.6001–1 as a reference to chapter 41.

(b) *Cross references.* See § 56.4911–6 for general information on records of lobbying expenditures. See §§ 56.4911–9(d) and 56.4911–10(f) for information that members of an affiliated group and a limited affiliated group, respectively, are to provide to other members of the group and to the Internal Revenue Service.

§ 56.6011–1 General requirement of return, statement, or list.

Every organization liable for the tax imposed by section 4911(a) shall file an annual return with respect to the tax on the form prescribed by the Internal Revenue Service for that purpose and shall include the information required by the form and its instructions.

§ 56.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

(a) *In general.* If a transaction is identified as a *listed transaction* or a *transaction of interest* as defined in § 1.6011–4 of this chapter by the Commissioner in published guidance (see § 601.601(d)(2) of this chapter), and the listed transaction or transaction of interest involves an excise tax under chapter 41 of subtitle D of the Internal Revenue Code (relating to public charities), the transaction must be disclosed in the manner stated in such published guidance.

(b) *Effective date.* This section applies to listed transactions entered into on or after January 1, 2003. This section applies to transactions of interest entered into on or after November 2, 2006.

[T.D. 9350, 72 FR 43154, Aug. 3, 2007]

§ 56.6060–1 Reporting requirements for tax return preparers.

(a) *In general.* A person that employs one or more tax return preparers to prepare a return or claim for refund of tax under chapter 41 of subtitle D of the Internal Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 56.6107–1 Tax return preparer must furnish copy of return and claim for refund to taxpayer and must retain a copy or record.

(a) *In general.* A person who is a signing tax return preparer of any return

or claim for refund of tax under Chapter 41 of subtitle D of the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the public charity and retain a completed copy or record in the manner stated in § 1.6107–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 56.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund.

(a) *In general.* Each tax return or claim for refund for tax under chapter 41 of subtitle D prepared by one or more signing tax return preparers must include the identifying number of the preparer required by § 1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in § 1.6109–2 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 56.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general.* For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund of tax under chapter 41 of subtitle D see § 1.6694–1 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 56.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of excise tax under chapter 41 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 56.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under chapter 41 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78460, Dec. 22, 2008]

§ 56.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection when a tax return preparer who prepared a return or claim for refund for tax under chapter 41 of subtitle D of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 56.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under chapter 41 of subtitle D of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of

the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 56.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules relating to claims for credit or refund by a tax return preparer who prepared a return or claim for refund for tax under chapter 41 of subtitle D of the Internal Revenue Code, the rules under § 1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 56.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see § 301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

PART 141—TEMPORARY EXCISE TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

§ 141.4975–13 Definition of "amount involved" and "correction".

Until superseded by permanent regulations under sections 4975(f) (4) and (5), § 53.4941(e)–1 of this chapter (Foundation Excise Tax Regulations) will be controlling to the extent such regulations describe terms appearing both in section 4941(e) and section 4975(f). Because of the need for immediate guidance with respect to the provisions contained in this Treasury decision, it is found impracticable to issue it with notice and public procedure thereon under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

(Sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7425, 41 FR 32890, Aug. 6, 1976, as amended by T.D. 8084, 51 FR 16305, May 2, 1986]

PART 143—TEMPORARY EXCISE TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1969

Sec.

143.1 [Reserved]
143.2 Taxes on self-dealing; scholarship and fellowship grants by private foundations.
143.3–143.4 [Reserved]
143.5 Taxes on self-dealing; indirect transactions by a private foundation.
143.6 Election to shorten the period during which certain excess business holdings of private foundations are treated as permitted holdings.

AUTHORITY: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805.

§ 143.1 [Reserved]

§ 143.2 Taxes on self-dealing; scholarship and fellowship grants by private foundations.

(a) *In general.* Section 4941(d)(1)(D) of the Internal Revenue Code of 1954 as added by section 101(b) of the Tax Reform Act of 1969 (83 Stat. 500) provides that the term ''self-dealing'' includes any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person. Section 4941(d)(1)(E) provides that the term ''self-dealing'' includes any direct or indirect transfer to, or use by, or for the benefit of, a disqualified person of the income or assets of a private foundation.

(b) *Scholarship and fellowship grants.* A scholarship or fellowship grant to a person other than a Government official paid or incurred by a private foundation in accordance with a program which is consistent with the allowance of a deduction under section 170 for contributions made to such private

foundation shall not constitute an act of self-dealing. For example, a scholarship or fellowship grant made by a private foundation in accordance with a program to award scholarship or fellowship grants to the children of employees of the donor shall not constitute an act of self-dealing if the private foundation has, after disclosure of the method of carrying out such program, received a ruling or determination letter stating that it is exempt from taxation under section 501(c)(3) and that contributions to the private foundation are deductible by the donor under section 170.

[T.D. 7030, 35 FR 4293, Mar. 10, 1970]

§§ 143.3–143.4 [Reserved]

§ 143.5 Taxes on self-dealing; indirect transactions by a private foundation.

(a) *In general.* Section 4941(d)(1)(D) of the Internal Revenue Code of 1954 as added by section 101(b) of the Tax Reform Act of 1969 (83 Stat. 500) provides that the term ''self-dealing'' includes any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person. Section 4941(d)(1)(E) provides that the term ''self-dealing'' includes any direct or indirect transfer to, or use by, or for the benefit of, a disqualified person of the income or assets of a private foundation. Section 4941(d)(1)(F) provides that the term ''self-dealing'' includes any direct or indirect agreement by a private foundation to make any payment of money or other property to a government official other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90–day period.

(b) *Indirect transactions by a private foundation.* A transaction engaged in directly with a Government official by an organization described in section 509(a) (1), (2), or (3) which is the recipient of a grant from a private foundation shall not constitute an indirect act of self-dealing between such private foundation and Government official if the private foundation does not earmark the use of the grant for any named Government official and does not control or retain any veto power over the selection of the Government official by the grantee organization. For purposes of the preceding sentence, a grant by a private foundation shall not constitute an indirect act of self-dealing even though such foundation had reason to believe that certain Government officials would derive benefits from such grant so long as the grantee, in fact, exercises control over the selecting process and actually makes the selection completely independent of the private foundation.

(c) *Example.* The provisions of subsection (b) of this section may be illustrated by the following example.

Example. A private foundation made a grant to an organization described in section 509(a) (1), (2), or (3) to conduct a judicial seminar. The grantee conducting the seminar made payments to certain Government officials. By the nature of the seminar the grantor foundation had reason to believe that Government officials would be compensated for participation in such seminar. The grantee, however, had complete independent control over the selection of such participants. Since the grantee has not acted as a conduit for the private foundation and has, in fact, exercised independent control over the use of the grant, such grant by the private foundation shall not constitute an act of self-dealing with respect to the Government officials.

[T.D. 7036, 35 FR 6322, Apr. 18, 1970]

§ 143.6 Election to shorten the period during which certain excess business holdings of private foundations are treated as permitted holdings.

(a) *In general.* Under section 4943(c)(4)(B)(ii), where the combined holdings on May 26, 1969, of a private foundation and all disqualified persons in any one business enterprise exceed 75 percent of the voting stock or more than a 75 percent interest in the value of all outstanding shares of all classes of stock in such enterprise, and the foundation's holdings on such date do not exceed 95 percent of the voting stock in such enterprise, then such combined holdings must be reduced to 50 percent of the voting stock of such enterprise by the end of a 15–year period beginning on May 26, 1969. However, under section 4943(c)(4)(E), the 15–

year period during which such combined holdings in the enterprise must be reduced to 50 percent is to be shortened to a 10–year period, referred to in section 4943(c)(4)(B)(iii), if, at any time before January 1, 1971, one or more individuals:

(1) Who are substantial contributors (as described in section 507(d)(2)) or members of the family within the meaning of section 4946(d) of one or more substantial contributors to such private foundation, and

(2) Who on May 26, 1969, held in aggregate more than 15 percent of the voting stock of the enterprise, make an election in the manner described in paragraph (b). If an individual who owns 15 percent or less of the voting stock of the enterprise wishes to make an election under this paragraph, he and one or more other individuals who together own more than 15 percent of the voting stock of the enterprise may join in making an election by together filing the statement referred to in paragraph (b) of this section.

(b) *Manner of making election.* The election referred to in paragraph (a) of this section is made by filing two copies of a written statement with the Office of the Assistant Commissioner (Technical), Internal Revenue Service, Washington, DC 20224.

(c) *Additional copies.* The individual filing the written statement referred to in paragraph (b) of this section shall submit a copy of the statement to the private foundation with respect to which the election is being made and to the management of such business enterprise.

(d) *Content of statement.* The statement shall indicate that an election is being made under section 4943(c) (4)(E) of the Code, and shall be signed by each of the individuals making the election, and, in addition shall contain the following information:

(1) The name, address, and taxpayer identification number of each of the individuals making the election;

(2) The name and address of the foundation with respect to which such election is being made;

(3) The name and address of the business enterprise with respect to which the election is being made;

(4) The aggregate number of shares of voting stock in the business enterprise that were held on May 26, 1969, by each individual making the election, and, in addition, the percentage that such voting stock is of the total number of shares of voting stock issued and outstanding on such date;

(5) The aggregate number of shares of voting stock in the business enterprise held by the private foundation on May 26, 1969, and, in addition, the percentage that such voting stock is of the total number of shares of voting stock issued and outstanding on such date; and

(6) The total number of shares of voting stock in the business enterprise or the best available estimate thereof, that were issued and outstanding on May 26, 1969.

(e) *Time for making election.* The statement referred to in paragraph (b) of this section shall be filed before January 1, 1971.

[T.D. 7038, 35 FR 6962, May 1, 1970]

PART 145—TEMPORARY EXCISE TAX REGULATIONS UNDER THE HIGHWAY REVENUE ACT OF 1982 (PUB. L. 97–424)

Sec.

145.4051–1 Imposition of tax on heavy trucks and trailers sold at retail.
145.4052–1 Special rules and definitions.
145.4061–1 Application to manufacturers tax.

AUTHORITY: 26 U.S.C. 7805.

Sections 145.4051–1 and 145.4052–1 also issued under 26 U.S.C. 4051 and 4052.

SOURCE: T.D. 7882, 48 FR 14362, Apr. 4, 1983, unless otherwise noted.

§ 145.4051–1 Imposition of tax on heavy trucks and trailers sold at retail.

(a) *Imposition of tax*—(1) *In general.* Section 4051(a)(1) imposes a tax on the first retail sale (as defined in § 145.4052–1(a)) of the following articles (including in each case parts or accessories therefor sold on or in connection therewith or with the sale thereof):

(i) Automobile truck chassis and bodies;

(ii) Truck trailer and semitrailer chassis and bodies; and

(iii) Tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

A sale of an automobile truck, truck trailer or semitrailer, shall be considered to be a sale of a chassis and of a body enumerated in this paragraph (a)(1).

(2) *Special rule applicable to chassis and bodies.* A chassis or body enumerated in paragraph (a)(1) of this section is taxable under section 4051(a)(1) only if such chassis or body is sold for use as a component part of a highway vehicle (as defined in paragraph (d) of § 48.4061(a)–1 (Regulations on Manufacturers and Retailers Excise Taxes)), which is an automobile truck, truck trailer or semitrailer, or a tractor of the kind chiefly used for highway transportation in combination with a trailer or semitrailer. Furthermore, a chassis or body which is not enumerated in paragraph (a)(1) of this section is not taxable under section 4051(a)(1) even though such chassis or body is used as a component part of a highway vehicle (e.g., a chassis or body of a passenger automobile). See paragraphs (e)(1) and (e)(2) of this section for the definitions of a tractor and truck. See paragraphs (e) (1) through (5) of § 145.4052–1 for other provisions applicable to this section. See paragraph (f) of this section, relating to tax-free sales of non-highway vehicles.

(3) *Parts or accessories sold on or in connection with chassis, bodies, etc.* The tax applies in respect of parts or accessories sold on or in connection with or with the sale of the vehicles specified in section 4051(a)(1). Thus, for example, if at the time the article is sold by the retailer, the part or accessory has been ordered from the retailer, the part or accessory will be considered as sold in connection with and with the sale of the vehicle. The tax applies in such a case whether or not the parts or accessories are billed separately by the retailer. If a taxable chassis, body, or tractor is sold by the retailer, without parts or accessories which are considered equipment essential for the operation or appearance of the taxable article, the sale of such parts or accessories by the retailer to the purchaser of the taxable article will be considered, in the absence of evidence to the contrary, to have been made in connection with the sale of the taxable article even though they are shipped separately, at the same time or on a different date. For example, if a retailer sells to any person a chassis and the bumpers for such chassis, or sells a taxable tractor and the fifth wheel and attachments, the tax applies to such parts or accessories regardless of the method of billing or the time at which the shipments were made. Parts and accessories that are spares or replacements are not subject to tax.

(4) *Exclusions.* No tax is imposed by section 4051(a)(1) on the sale of automobile truck chassis and bodies, suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less, or truck trailer and semitrailer chassis and bodies, suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less. For purposes of this paragraph (a)(4) the term *suitable for use* means practical and commercial fitness for such use. A chassis or body possesses practical fitness for use with a vehicle if it performs its intended function up to a generally acceptable standard of efficiency with the vehicle, and a chassis or body possesses commercial fitness for use with a vehicle if it is generally available for use with the vehicle at a price that is reasonably competitive with other articles that may be used for the same purpose. Thus, a truck chassis which is suitable for use with a vehicle having a gross vehicle weight of 33,000 pounds or less, is not subject to the tax imposed by section 4051(a)(1) regardless of the body actually mounted thereon. A truck trailer or semitrailer chassis suitable for use with a vehicle having a gross vehicle weight of 26,000 pounds or less, is not subject to tax regardless of the body actually mounted thereon. Where an exempt body is mounted on a taxable chassis, or a taxable body is mounted on an exempt chassis, the taxable chassis or body, as the case may be, nevertheless remains subject to such tax, if the resulting vehicle is a highway vehicle as defined in § 48.4061(a)–1.

(b) *Rate of tax.* With respect to the articles enumerated in paragraph (a)(1) of this section, the rate of tax imposed by section 4051(a)(1) is 12 percent of the

price for which the article is sold on or after April 1, 1983. See paragraph (d) of this section relating to vehicles on which a 10 percent tax was imposed under section 4061(a)(1).

(c) *Separate purchase of truck or trailer and parts and accessories therefor*—(1) *In general*. If the owner, lessee, or operator of any vehicle, which contains an article taxable under paragraph (a)(1) of this section, installs (or causes to be installed) any part or accessory on such vehicle, and such installation is not later than 6 months after the date such vehicle (as it contains such article) was first placed in service, section 4051(b)(1) imposes a tax on such installation equal to 12 percent of the price of such part or accessory and its installation. For purposes of the tax imposed by section 4051(b)(1) and this paragraph (c)(1) the term ''parts and accessories'' does not include those parts and accessories which were previously exempt from tax under sections 4061(b) (1) and (2) as in effect prior to January 7, 1983. Thus, for example, articles of general use are exempt from tax. See § 48.4061(b)–2 (b). See paragraphs (d) (1) through (4) of § 145.4052–1 for determination of price.

(2) *Placed in service*. For purposes of paragraph (c)(1) of this section, a vehicle shall be considered placed in service on the date on which the owner of the vehicle took actual possession of the vehicle. This date can be established by the delivery ticket signed by the owner or other comparable document indicating delivery to and acceptance by the owner.

(3) *Exceptions*. The tax imposed by section 4051(b)(1) and paragraph (c)(1) of this section shall not apply if:

(i) The part or accessory intalled is a replacement part or accessory, or

(ii) The aggregate price of the parts and accessories (and their installation) described in paragraph (c)(1) of this section with respect to any vehicle does not exceed $200.

For purposes of paragraph (c)(3)(i) of this section, a part is a replacement part, regardless of when it is ordered, if its use with a vehicle is as a replacement for a part on such vehicle. For purposes of paragraph (c)(3)(ii) of this section, the term *aggregate price of parts and accessories (and their installation)* refers to all purchases and installation charges, not including replacement parts and accessories, made with respect to a vehicle within the 6 month period provided for in paragraph (c)(1) of this section. If the aggregate price of parts and accessories (and their installation) during the 6 month period exceeds $200, the tax imposed under section 4051(b)(1) and paragraph (c)(1) of this section shall apply to the cost of all parts and accessories (and their installation) during such period. For example, a vehicle is purchased and placed in service on July 1, 1983. On August 1, 1983, the owner purchases and has installed parts and accessories at a cost of $150. On September 1, 1983, the owner purchases and has installed parts and accessories at a cost of $300. On September 1, 1983 a tax of $54 will be imposed (12 percent × $450). Any costs of additional parts and accessories installed with respect to the vehicle before January 1, 1984 (and the cost of installation) will also be subject to the 12 percent tax.

(d) *Transitional rule*. In the case of an article taxable under paragraph (a)(1) of this section, on which a tax was imposed under section 4061(a)(1), the rate of tax set forth in paragraph (b) shall be applied by substituting ''2 percent'' for ''12 percent.'' For example, if a manufacturer sells a tractor to a dealer on February 1, 1983, for $20,000 (which includes the Federal excise tax), for which a 10 percent tax was paid, and the dealer sells the tractor on April 10, 1983 for $25,000, a tax of 2 percent will be imposed on the $25,000 sales price. See paragraphs (d) (1) through (4) of § 145.4052–1 relating to determination of price.

(e) *Definitions*. For purposes of this section:

(1) *Tractor*. (i) The term ''tractor'' means a highway vehicle primarily designed to tow a vehicle, such as a trailer or semitrailer, but does not carry cargo on the same chassis as the engine. A vehicle equipped with air brakes and/or towing package will be presumed to be primarily designed as a tractor.

(ii) An incomplete chassis cab shall be treated as a tractor if it is equipped with one or more of the following:

(A) A device for supplying pressure from the chassis cab to the brake system (air or hydraulic) of the towed vehicle;

(B) A mechanism for protecting the chassis cab brake system from the effects of a loss of pressure in the brake system of the towed vehicle;

(C) A control linking the brake system of the chassis to the brake system of the towed vehicle;

(D) A control in the cab for operating the towed vehicle's brakes independently of the chassis cab's brakes; or

(E) Any other equipment designed to make it suitable for use as a tractor.

An incomplete chassis cab which is not equipped with any of the devices set forth in paragraphs (e)(1)(ii) (A) through (E) of this section shall be treated as a truck if the purchaser certifies in writing that the vehicle will not be equipped for use as a tractor.

(2) *Truck*. The term ''truck'' refers to a highway vehicle that is primarily designed to transport its load on the same chassis as the engine even if it is also equipped to tow a vehicle, such as a trailer or semitrailer.

(3) *Gross vehicle weight*. (i) For purposes of this section the term ''gross vehicle weight'' means the maximum total weight of a loaded vehicle. Except as otherwise provided in paragraphs (e)(3) (ii) through (v) of this section, such maximum total weight shall be the gross vehicle weight rating of the article as specified by the manufacturer or established by the seller of the completed article, unless the Commissioner finds that such rating is unreasonable in light of the facts and circumstances in a particular case.

(ii) A seller must specify or establish a weight rating for each chassis, body, or vehicle sold on or after April 1, 1983 if such article requires no additional manufacture other than (A) the addition of readily attachable articles, such as tire or rim assemblies or minor accessories, (B) the performance of minor finishing operations, such as painting, or (C) in the case of a chassis, the addition of a body. If an article is specially equipped to the purchaser's specifications, such specifications may be used to establish the gross vehicle weight of the article.

(iii) A seller shall maintain a record of the gross vehicle weight rating of each truck, trailer and semitrailer sold and excluded from the tax imposed by section 4051(a)(1) by reason of sections 4051(a) (2), (3) and paragraphs (e)(3) (i) through (v) of this section. For this purpose, a record of the serial number of each such article shall be treated as a record of the gross vehicle weight rating of the article if such rating is indicated by the serial number.

(iv) If (A) the seller's rating indicated in a label or identifying device affixed to an article, (B) the rating set forth in the sales invoice or warranty agreement, and (C) the advertised rating for that article (or two or more identical articles) are inconsistent, the highest of such ratings will be considered to be the seller's gross vehicle weight rating specified or established for purposes of the tax imposed by section 4051(a)(1).

(v) The seller's gross vehicle weight rating must take into account, among other things, the strength of the chassis frame and the axle capacity and placement. The Commissioner may exclude from the gross vehicle weight rating any readily attachable parts to the extent the Commissioner finds that the use of such parts in computing the gross vehicle weight rating is unreasonable.

(f) *Tax-free sales*. With respect to tax-free sales of a chassis or body for use as a component of a vehicle other than a highway vehicle, similar provisions to paragraphs (e)(2) (ii), (iii), and (iv) of § 48.4061(a)–1 shall apply.

(g) *Effective date*. The provisions of this section shall be effective for articles sold on or after April 1, 1983.

[T.D. 7882, 48 FR 14362, Apr. 4, 1983, as amended by T.D. 8879, 65 FR 17164, Mar. 31, 2000]

§ 145.4052–1 Special rules and definitions.

(a) *First retail sale*—(1) *General rule*. For purposes of section 4051(a)(1) and § 145.4051–1, the term ''first retail sale'' means a taxable sale described in paragraph (a)(2) of this section.

(2) *Taxable sale*. The sale of an article is a taxable sale unless—

(i) The sale is a tax-free sale under section 4221,

(ii) [Reserved]. For sales after June 30, 1998, see § 48.4052–1 of this chapter.

(iii) There has been a prior taxable sale of the article. Notwithstanding the preceding clause, the sale of a chassis or body of a trailer or semitrailer (''trailer or semitrailer'') less than six months after a taxable sale of the article shall be treated as a taxable sale.

(3) *Computation of tax*—(i) *In general*. If the sale of an article is a taxable sale under paragraph (a)(2) of this section, the tax shall be computed on the price as determined under paragraph (d) of this section.

(ii) *Exception*. If the taxable sale of an article is a taxable use of such article under paragraph (c) of this section, the tax shall be computed on the price as determined under paragraph (c) of this section.

(4) *Special rule for tax-paid trailer and semitrailer*. In the case of a taxable sale of a trailer or semitrailer less than six months after a taxable sale of the article, the seller in the subsequent sale (''the subsequent seller'') may claim a credit equal to the amount of tax previously paid by another person (''the previous taxpayer'') under section 4051(a)(1) with respect to the prior taxable sale of the article. The credit for such tax will be allowed to the subsequent seller only if the form on which the credit is claimed is accompanied by a statement, signed by the subsequent seller, indicating the amount of the credit being claimed under this paragraph (a)(4) and stating that—

(i) The subsequent seller has not been repaid any portion of such tax by the previous taxpayer,

(ii) The subsequent seller has not provided the previous taxpayer with written consent to allow the previous taxpayer to claim a credit or refund of such tax under section 6416 (a), and

(iii) The subsequent seller has records (e.g., invoices) substantiating the amount of tax paid by the previous taxpayer with respect to the prior taxable sale of such article.

In no case shall the amount of the credit allowable under this paragraph (a)(4) with respect to an article exceed the tax liability of the subsequent seller with respect to the sale of such article.

(5) *No installment payments of tax*. If a lease or an installment sale (or another form of sale under which the sales price is paid in installments) is, or is deemed to be, a taxable sale under this section, then the liability for the entire tax arises at the time of the lease or installment sale. No portion of the tax is deferred by reason of the fact that the sales price is paid in installments.

(6) *Certificate*. A certificate signed by the purchaser, or an officer or employee authorized by the purchaser to sign the certificate, may be accepted by a seller in support of a nontaxable sale to the purchaser. If it is impracticable to furnish a separate certificate for each sale because of the frequency of sales to such purchaser, a certificate covering all orders between given dates (such period not to exceed 12 calendar quarters) will be acceptable. The purchaser may revoke the certificate by sending a written revocation to the seller. The certificate and proper records of invoices, orders, etc., relating to sales made pursuant to such certificate, must be retained by the seller as provided in section 6001 and the regulations thereunder. The certificate shall be substantially in the following form:

EXEMPTION CERTIFICATE

I hereby certify that I am _____ (Title) of _____, (Name of purchaser) that I am authorized to execute this certificate, and that:

(Check appropriate line)

_____ the article or articles specified in the accompanying order, or on the reverse side hereof, (or)

_____ all orders placed by the purchaser for the period commencing _____ (Date) (period not to exceed 12 calendar quarters), are purchased either for resale or for lease on a long-term basis.

I have filed Form 637 and have received registration number _____.

I understand that the fraudulent use of this certificate to secure exemption will subject me and all parties making such fraudulent use to a fine of not more than $10,000, or to imprisonment for not more than 5 years, or both, together with costs of prosecution.

_____
(Signature)

_____
(Address)

(b) *Tax treatment of leases*—(1) *Long-term lease*. For purposes of this section and § 145.4051–1, the leasing of an article on a long-term basis (as defined in paragraph (d)(6) of this section) will be

deemed to be a sale of the article and will be deemed to be a taxable sale unless one of the exceptions contained in paragraph (a)(2) of this section applies. Thus, if a dealer purchases an article tax-free under an exception contained in paragraph (a)(2) of this section and then leases the article on a long-term basis, the leasing of the article will be treated as a taxable sale.

(2) *Short-term lease*. For purposes of this section and § 145.4051–1, the leasing of an article on a short-term basis (as defined in paragraph (d)(6) of this section) will be deemed to be a taxable use of such article under paragraph (c) of this section and will be deemed to be a taxable sale unless one of the exceptions contained in paragraph (a)(2) of this section applies.

(3) *Computation of tax*—(i) *Long-term lease by manufacturer, producer, or importer*. When a manufacturer, producer, or importer is the lessor of an article on a long-term basis (as defined in paragraph (d)(6) of this section) and such lease is deemed to be a taxable sale under paragraph (b)(1) of this section, the tax shall be computed on a presumptive retail sales price as determined under paragraph (d)(4)(i) of this section. The manufacturer, producer, or importer shall be liable for the tax as if the article were sold at retail by such manufacturer, importer, or retailer.

(ii) *Long-term lease by persons other than manufacturer, producer, or importer*. When a person other than a manufacturer, producer, or importer is the lessor of an article on a long-term basis (as defined in paragraph (d)(6) of this section) and such lease is deemed to be a taxable sale under paragraph (b)(1) of this section, the tax shall be computed on a presumptive retail sales price as determined under paragraph (d)(5) (i) of this section. Such person shall be liable for the tax as if the article were sold at retail by such person.

(c) *Use treated as sale*—(1) *In general*. For purposes of this section and § 145.4051–1, the use of an article will be deemed to be a sale of the article. Furthermore, if a person purchases a vehicle for which no tax was imposed under section 4051(a)(1) and thereafter converts such vehicle into an article which would have been taxable under section 4051(a)(1) and uses it, such person shall be liable for the tax as if such article were sold at retail by such person. For example, a truck having a gross vehicle weight rating of 24,000 pounds is sold at retail. The purchaser adds a lift axle, thereby increasing the gross vehicle weight rating to 34,000 pounds. If the purchaser thereafter uses the vehicle the purchaser shall be liable for the tax as if such article were sold at retail.

(2) *Exemption for use in further manufacture*. The tax on the use of an article to which paragraph (c)(1) of this section applies shall not apply to use of the article by such person as material in the manufacture or production of, or as a component part of, another article to be manufactured or produced by the same user.

(3) *Time of application of tax*. In the case of taxable use of an article by the seller, the tax attaches at the time such use begins. It tax applies by reason of the sale of an article on or in connection with, or with the sale of another article, the tax attaches at the time of the sale of such other article.

(4) *Events subsequent to taxable use of article*. Liability for tax incurred on the use of an article is not extinguished or reduced because of any subsequent sale or lease of the article even if such sale or lease would have been exempt if the article had been sold or leased prior to use. If a seller of an article incurs liability for tax on his or her use of an article, and thereafter sells or leases the article in a transaction which otherwise would be subject to tax, liability for tax is not incurred on such sale or lease.

(5) *Computation of tax*. (i) Except as provided in paragraphs (c)(5)(ii) and (c)(5)(iii) of this section.

(ii) If the seller of an article regularly sells such articles at retail in arm's length transactions, tax liability on its use of any such article shall be computed on its lowest established retail price for such articles in effect at the time of the taxable use. In establishing such price, there shall be included and excluded, as applicable, the charges and readjustments specified in sections 4216(a), 4216(f), and 6416(b)(1) as in effect at the time the tax liability on the use of the article is incurred. If

the seller of an article does not regularly sell such articles at retail in arm's length transactions, a constructive price on which the tax shall be computed will be determined by the Commissioner. This price will be established after considering the selling practices and price structures of sellers of similar articles.

(iii) In the case of any short-term lease (as defined in paragraph (d)(6) of this section) by any person other than a manufacturer, producer, or importer (or related person as defined in paragraph (d)(2)(ii) of this section) of an article that is deemed to be a taxable use of such article under paragraph (b)(2) of this section, the tax imposed by section 4051(a)(1) shall be computed on a price equal to the sum of—

(A) The price (as determined under paragraph (d) of this section) at which such article was sold to the lessor plus the cost of any parts and accessories installed by the lessor (or an agent of the lessor) on such article before the first use or lease by the lessor, plus

(B) The product of the sum described in paragraph (c)(5)(iii)(A) of this section and the presumed markup percentage (as defined in paragraph (d)(7) of this section).

(d) *Determination of price*—(1) *In general.* The price for which an article is sold includes the total consideration paid for the article whether that consideration is paid in money, services, or other forms. In addition, there shall be included any charge incident to placing the article in condition ready for use. Similar rules to section 4216(a) and the regulations thereunder, relating to charges to be included in the price and excluded from the price, shall apply. For example, charges for transportation, delivery, insurance, and installatioin (other than installation charges to which section 4051(b) applies), and other expenses actually incurred in connection with the delivery of an article to a purchaser pursuant to a bona fide sale shall be excluded from the price in computing the tax.

(2) *Presumptive retail sales price where tax paid by manufacturer, producer, or importer*—(i) *In general.* In the case of a taxable sale (other than a taxable sale described in paragraph (b)(1) of this section) where a manufacturer, producer, importer, or related person is liable for the tax imposed by section 4051, such tax shall be computed on a price equal to the sum of—

(A) The price that would (but for this paragraph (d)(2)) be determined under this paragraph (d), and

(B) The product of the price determined under paragraph (d)(2)(i)(A) of this section and the presumed markup percentage (as defined in paragraph (d)(7) of this section).

(ii) *Related person defined*—(A) *In general.* Except as provided in paragraph (d)(2)(ii)(B) of this section, the term ''related person'' means any person that is a member of the same controlled group (within the meaning of section 5061(e)(3)) as the manufacturer, producer, or importer.

(B) *Exception for permanent retail establishment.* A person shall not be treated as a related person with respect to the sale of any article if—

(*1*) Such person sells the article through a permanent retail establishment in the normal course of business of being a retailer, and

(*2*) Such person has records (e.g., invoices) that substantiate that the article was sold for a price that included a markup equal to or greater than the presumed markup percentage (as defined in paragraph (d)(7) of this section).

(3) *Retail sales price where tax paid by person other than a manufacturer, producer, importer, or related person*—(i) *In general.* In the case of a taxable sale (other than a taxable sale defined in paragraph (b)(1) of this section) where a person other than a manufacturer, producer, importer, or related person is liable for the tax imposed by section 4051, such tax shall be computed on a price determined under paragraph (d)(1) of this section.

(ii) *Exception.* When a person other than a manufacturer, producer, importer, or related person is liable for the tax imposed by section 4051, such tax shall be computed on a price determined under paragraph (d)(2)(i) of this section if—

(A) Such person does not perform any significant activities relating to the processing of the sale of an article,

(B) The principal purpose for processing the sale through such person is

to avoid or evade the presumed markup under paragraph (d)(2)(i)(B) of this section, and

(C) Such person does not have records (e.g., invoices) substantiating that the article was sold for a price that included a markup equal to or greater than the presumed markup percentage as defined in paragraph (d)(7) of this section.

(4) *Presumptive retail sales price in the case of a lease by a manufacturer, producer, or importer.* In the case of any long-term lease (as defined in paragraph (d)(6) of this section) by a manufacturer, producer, importer, or a related person (as defined in paragraph (d)(2)(ii) of this section) of an article that is deemed to be a taxable sale of such article under paragraph (b)(1) of this section, the tax imposed by section 4051(a)(1) shall be computed on a price equal to the sum of—

(i) A constructive sales price established by the Commissioner based on the price at which such article would be sold by a manufacturer, producer, or importer in a sale other than a taxable sale (e.g., a sale to which the exceptions contained in paragraph (a)(2)(ii) of this section applies) on the date the lease is made, and

(ii) The product of the constructive sales price referred to in paragraph (d)(4)(i) of this section and the presumed markup percentage as defined in paragraph (d)(7) of this section.

(5) *Presumptive retail sales price in the case of a long-term lease by any other person.* In the case of any long-term lease (as defined in paragraph (d)(6) of this section) of an article in which any person other than a manufacturer, producer, or importer (or related person as defined in paragraph (d)(2)(ii) of this section) is the lessor and the long-term lease is deemed to be a taxable sale of such article under paragraph (b)(1) of this section, the tax imposed by section 4051(a)(1) shall be computed on a price equal to the sum of—

(i) The price (as determined under this paragraph (d)) at which such article was sold to the lessor plus the cost of any parts and accessories installed by the lessor (or an agent of the lessor) on such article before the first use by the lessee or leased in connection with such long-term lease, and

(ii) The product of the sum described in paragraph (d)(5)(i) of this section and the presumed markup percentage as defined in paragraph (d)(7) of this section.

(6) *Long-term and short-term lease defined.* For purposes of this section, the term ''long-term lease'' means any lease with a term of one year or more. The term ''short-term lease'' means any lease with a term of less than one year. In determining a lease term, options to renew shall be taken into account. In addition, two or more successive leases that are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar article, shall be treated as one lease.

(7) *Presumed markup percentage*—(i) *In general.* Except as provided in paragraph (d)(7)(ii) of this section, for purposes of this section the term ''presumed markup percentage'' shall be four percent.

(ii) *Exceptions.* For purposes of this section the ''presumed markup percentage'' for trailers, semitrailers, and remanufactured automobile truck chassis and bodies and tractors shall be zero percent. For purposes of this section an article is a remanufactured article if—

(A) The refurbishing, renovation, or repair of the article causes it to be subject to the tax imposed by section 4051, and

(B) Before remanufacture, such article was previously subject to the tax imposed by section 4051 (or section 4061 prior to its repeal).

(8) *Items excluded from price.* There shall be excluded from the price:

(i) The amount ot tax imposed under sections 4051(a)(1) and (b)(1);

(ii) If stated as a separate charge, the amount of any retail sales tax imposed by any state or political subdivision thereof or the District of Columbia, whether the liability for such tax is imposed on the vendor or vendee; and

(iii) The fair market value (including any tax imposed by section 4071) at retail of any tires (not including any metal rim or rim base). For purposes of this paragraph (d)(8)(iii), fair market value at retail shall be determined by the lowest established price for which the vehicle retailer would sell such

tires at retail in the ordinary course of trade. The lowest established price is the lowest price for which the vehicle retailer sells, or offers to sell, a single tire to an independent purchaser who would not ordinarily be expected to buy more than one. If the vehicle retailer has no lowest established price the Commissioner will accept any price provided, under the facts and circumstances, such price is not unreasonable. For vehicles sold on or after April 1, 1983, and before October 13, 1985, a price will not be considered unreasonable if it is no more than an amount equal to 50 percent of the manufacturer's suggested retail price.

(9) *Trade-ins.* If, in connection with the sale of an article subject to the tax imposed under section 4051(a)(1) or (b)(1) on the price for which sold, a vendor receives from its vendee another article in exchange, the tax on the vendor's sale shall be computed on the basis of the full price of the article sold, unreduced by any amount allowed for the article received from the vendee. For example, where a vehicle costing $20,000 is purchased for $16,000 cash plus a used vehicle valued at $4,000, tax is $2,400 (12 percent × $20,000).

(10) *Sales not at arm's length.* For purposes of § 145.4051–1 and this section, a sale is considered to be made under circumstances otherwise than at ''arm's length'' if:

(i) One of the parties is controlled (in law or in fact) by the other, or there is common control, whether or not such control is actually exercised to influence the sale price, or

(ii) The sale is made pursuant to special arrangements between a seller and a purchaser.

In the case of an article sold otherwise than at arm's length, and sold at less than the fair market price, the tax imposed under section 4051(a)(1) or (b)(1) shall be computed on the price for which similar articles are sold at retail in the ordinary course of trade, as determined by the Commissioner. Once such a price has been determined, no further adjustment of such price shall be made.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. M manufactures trucks that are taxable under section 4051. On July 11, 1988, D, a corporation that is a dealer, purchases one truck from M for $50,000. M does not own any stock in D. Prior to this transaction, D gave M a certificate that meets the specifications detailed in paragraph (a)(6) of this section. The certificate states that the truck will be resold or leased on a long-term basis. M's sale to D is not a taxable sale of the truck (within the meaning of paragraph (a)(2) of this section). On July 20, 1988, D resells the truck to a purchaser, P, for $52,000. The additional $2,000 includes the dealer's mark-up, costs of transporting the truck from M to D, and overhead. No parts or accessories were added to the truck. P did not give D a certificate and did not have an agreement with D under which all vehicles purchased were to be resold. The sale of the truck by D to P is a taxable sale within the meaning of paragraph (a)(3) of this section. Therefore, D has a tax liability of $6,240 (12%×$52,000).

Example 2. Assume the same facts as in example (1) except that M owns 80 percent of D's stock. D and M are members of the same controlled group (within the meaning of section 5061(e)(3)). Therefore, D is a related person under paragraph (d)(2)(ii)(A) of this section. On July 20, 1988, D sells the truck to P for $51,000. D does not have records substantiating that the truck was sold for a price that included a markup equal to or greater than the presumed markup percentage. The tax on the sale of the truck to P is determined under paragraph (d)(2)(i) of this section. Therefore, D has a tax liability of $6,240 [(12%×($50,000+($50,000×4%))].

Example 3. Assume the same facts as in example (1) except that D does not perform any significant activities relating to the sale. Assume further that the principal purpose for processing the sale through D is to avoid the presumed markup and that D did not sell the truck for a price that included a markup equal to or greater than the presumed markup percentage. D, however, is designated the seller of the truck on the invoice. Pursuant to paragraph (d)(3)(ii) of this section, the price of the truck shall be computed on a price determined under paragraph (d)(2)(i). Therefore, D, the taxpayer, has a tax liability of $6,240 [12%×($50,000+($50,000×4%))].

Example 4. Assume the same facts as in example (1) except that on July 20, 1988, D leases the truck for a two-year period (*i.e.*, on a long-term basis) to L, a lessee. D's leasing of the truck to L is treated as a taxable sale under paragraph (b)(1) of this section and the tax is computed on the price as determined under paragraph (d)(5)(i) of this section. D has a tax liability of $6,240 [12%×($50,000+($50,000×4%))].

Example 5. Assume the same facts as in example (1) except that on July 20, 1988. D leases the truck to L for a six-month period

(*i.e.*, a short-term lease). The lease is treated as a use under paragraph (b)(2) of this section. The tax is computed on the price as determined under paragraph (c)(5) of this section. D has a tax liability of $6,240 [12%×($50,000+($50,000×4%))].

Example 6. Assume the same facts as in example (1) except that D does not give M a certificate. The sale by M to D is a taxable sale of the truck under paragraph (a)(2) of this section. M's tax liability is $6,240 [12%×($50,000+($50,000×4%))]. On July 20, 1988, D leases the truck to L, a lessee. The lease has a two-year term. Since the lease to L occurred after a taxable sale of the truck, paragraph (b)(1) of this section does not apply, and the lease is not treated as a taxable sale under this section.

Example 7. M manufactures trucks that are taxable under section 4051. On July 11, 1988, M leases a truck to a lessee, L. The lease has a two-year term. The lease is treated as a taxable sale under paragraph (b)(1) of this section and the tax is computed on the price as determined under paragraph (d)(4)(i) of this section. The constructive sales price established by the Commissioner, pursuant to paragraph (d)(4)(i) of this section, is $50,000. M has a tax liability of $6,240 [12%×($50,000+($50,000×4%))].

Example 8. Assume the same facts as in example (7) except that the lease has a six-month term. The lease is treated as a taxable use under paragraph (b)(2) of this section and the tax is computed under paragraph (c)(5) of this section. The constructive sales price established by the Commissioner, pursuant to paragraph (c)(5)(i) of this section, is $52,000. M has a tax liability of $6,240 (12%×$52,000).

Example 9. M manufactures truck trailers and semitrailers that are taxable under section 4051. On July 5, 1988, D, a dealer, purchases a trailer from M for $10,000. Prior to this transaction, D did not give M a certificate and D did not have an agreement with M to resell all articles purchased. The sale by M to D is a taxable sale of the trailer under paragraph (a)(2) of this section. M has a tax liability of $1,200 (12%×$10,000+($10,000×0%)).

Example 10. Assume the same facts as in example (9) except that on July 12, 1988, D resells the trailer to P, a purchaser, for $10,500 (the additional $500 includes the dealer's markup, costs of transporting the trailer from M to D, and overhead). P did not give D a certificate and P did not have an agreement with D that stipulates that all articles purchased were to be leased on a long-term basis or resold. The sale of the trailer by D to P is a taxable sale within the meaning of paragraph (a)(3) of this section. Therefore, D has a tax liability of $1,260(12%×$10,500). D, however, may file for a credit of $1,200 under section 6402 provided that the requirements of paragraph (a)(4) of this section are met.

(f) *Other rules made applicable.* For purposes of § 145.4051–1 and this section, rules similar to the following provisions shall apply:

(1) Section 48.0–2, relating to general definitions and attachment of tax;

(2) Paragraphs (a) (2) and (3) of § 48.4061 (a)–1;

(3) The exemptions provided by sections 4063 (a) and (d) and the regulations thereunder;

(4) Section 4216(f) and the regulations thereunder, relating to the incorporation of used components; and

(5) Section 4221 and the regulations thereunder, relating to certain tax-free sales.

(g) *Effective date*—(1) *In general.* Except as provided below, the provisions of this section shall be effective for articles sold or leased on or after April 1, 1983.

(2) *Certain sales made prior to November 12, 1985.* If a sale to a lessor before November 12, 1985, was not taxable under § 145.4052–1 of the temporary regulations contained in 26 CFR part 145 revised as of April 1, 1983, (the ''prior regulations'') and it was so treated by the parties, a subsequent sale or lease that was or would have been treated as the first retail sale of the article under the prior regulations will be treated as a taxable sale for purposes of this section. The tax on such subsequent sale will be based on a price determined under paragraph (d) of this section. For example, if an article was sold to a purchaser who intended to lease such article long-term, the sale would not have been taxable under the prior regulations even though the seller did not receive a certificate of the purchaser's intent to lease the vehicle. If such a sale was treated as nontaxable by the parties, and the purchaser leases it long-term on or after October 1, 1987, the lease will be treated as a taxable sale of the article. The tax is to be computed under paragraph (b)(3)(ii) of this section and the price will be computed under paragraph (d)(5).

(3) *Certain sales made after November 11, 1985, and before October 1, 1987*—(i) *Sales not treated as taxable by purchaser and seller.* If a sale to a purchaser after November 11, 1985, and before October 1, 1987, was not treated as taxable by the parties, a subsequent sale or lease

that was or would have been treated as the first retail sale of the article under the temporary regulations published in the September 13, 1985, issue of the FEDERAL REGISTER (50 FR 37350) (''the interim regulations'') will be treated as a taxable sale for purposes of this section. The tax on a sale or lease after September 30, 1987, will be based on a price determined under paragraph (d) of this section. For example, if a vehicle was sold on January 3, 1987, to a purchaser who intended to resell the article and who was not in the business of leasing to any extent, the sale would not have been taxable under the interim regulations even though the seller did not receive a certificate indicating the purchaser's intent to resell the article. If such a sale was not treated as a taxable sale by the parties, and the purchaser resells the article, the resale will be treated as a taxable sale of the article under paragraph (a)(2) of this section.

(ii) *Sales treated as first retail sale by purchaser and seller*. If the sale of an article after November 11, 1985, and before October 1, 1987, was treated as a taxable sale by the parties and tax was paid with respect to the article under the interim regulations, the subsequent sale of the article by the purchaser will not be treated as a taxable sale under paragraph (a)(2) of this section.

[T.D. 7882, 48 FR 14362, Apr. 4, 1983, as amended by T.D. 8050, 50 FR 37351, Sept. 13, 1985; T.D. 8200, 53 FR 16869, May 12, 1988; T.D. 8774, 63 FR 35804, July 1, 1998; T.D. 8879, 65 FR 17164, Mar. 31, 2000]

§ 145.4061–1 Application to manufacturers tax.

The provisions of § 145.4051–1(e) (1) and (2), relating to the definition of tractors and trucks, shall apply to section 4061(a)(1) for sales made on or after January 7, 1983. However, an incomplete chassis cab will be treated as a truck chassis for sales made on or after January 7, 1983, and before April 1, 1983. For purposes of section 4061, gross vehicle weight shall be determined under § 48.4061(a)–1(f)(3) (i) through (iv) for sales made on or after January 7, 1983, and before April 1, 1983.

PART 148—CERTAIN EXCISE TAX MATTERS UNDER THE EXCISE TAX TECHNICAL CHANGES ACT OF 1958

AUTHORITY: 26 U.S.C. 7805.

§ 148.1–5 Constructive sale price.

(a) *Purpose of this section*. The purpose of this section is to set forth temporary rules to be used in determining a constructive sale price under section 4216(b) of the Internal Revenue Code, as amended by section 115 of the Excise Tax Technical Changes Act of 1958, with respect to certain sales made on and after January 1, 1959, by a manufacturer, producer, or importer. The temporary rules set forth in this section have application in the case of articles in respect of which the manufacturer's excise tax imposed under Chapter 32 of the Code is based on the price for which the article is sold.

(b) *General rule*—(1) *Sales at retail*. Where a manufacturer, producer, or importer sells an article at retail, and the special rule provided in paragraph (c) of this section does not apply, the basis for tax shall be the lower of: (i) the actual price for which the article is sold; or (ii) the highest price for which such articles are sold to wholesale distributors, in the ordinary course of trade, by manufacturers or producers thereof. Thus, where a manufacturer, producer, or importer sells an article at retail, the tax on his retail sale ordinarily will be computed upon the highest price for which similar articles are sold by him to wholesale distributors. However, in such cases it must be shown that he has an established bona fide practice of selling such articles in substantial quantities to wholesale distributors. If he has no such sales to wholesale distributors, a fair market price will be determined by the Commissioner. In any case the price so determined shall not be in excess of the actual price for which the article is sold by him at retail.

(2) *Sales on consignment and sales otherwise than through an arm's length transaction*. For rules relating to the determination of a constructive sale price in the case of sales on consignment, or sales otherwise than through

an arm's length transaction and at less than the fair market price, see paragraphs (a) and (d) of § 316.15 of Regulations 46 (26 CFR (1939) part 316), as prescribed under and made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, 19 FR 5167, August 17, 1954.

(c) *Special rule*—(1) *Basis for tax.* Where a manufacturer, producer, or importer sells an article at retail, to a retailer, or to a special dealer, and the conditions specified in subparagraph (2) of this paragraph are met, a special constructure sale price rule is provided for computation of the tax. This rule provides that the tax is to be based on the lower of the following prices: (i) The actual price for which the article is sold; or (ii) the highest price for which such articles are sold by such manufacturer, producer, or importer to wholesale distributors (other than special dealers).

(2) *Conditions governing applicability of special rule.* In order to qualify for application of the special constructive sale price rule to the sale by the manufacturer, producer, or importer of an article at retail, to a retailer, or to a special dealer, the following four conditions must be satisfied.

(i) The manufacturer, producer, or importer of the article must regularly sell such articles at retail, to retailers, or to special dealers, as the case may be.

(ii) The manufacturer, producer, or importer of the article must regularly sell such articles to one or more wholesale distributors (other than special dealers) in arm's length transactions, and must establish that his prices in such cases are determined without regard to any tax benefit under this paragraph resulting from a reduction in the tax base for his sales at retail, to retailers, or to special dealers.

(iii) The normal method of sales within the industry embracing the article is not to sell at retail, or to retailers, or both.

(iv) The sale at retail, to a retailer, or to a special dealer must be an arm's length transaction.

(3) *Requests for determination.* In any case in which a manufacturer, producer, or importer desires a determination as to the application of this paragraph, he may request such a determination from the Commissioner. The request shall contain complete and detailed information with respect to each of the conditions specified in subparagraph (2) of this paragraph to assist the Commissioner in determining whether the constructive sale price provisions of this paragraph apply, such as data which will show the normal method of sales for the article within the industry by manufacturers, producers, and importers (including the dollar volume of sales at various distribution levels), and the source of such data; evidence as to the regularity with which sales of such articles are made by the manufacturer, producer, or importer at retail, to retailers, or to special dealers; information that the prices of the manufacturer, producer, or importer to wholesale distributors have been determined without regard to any tax benefit under the special rule of this paragraph; etc.

(d) *Definitions.* For purposes of this section:

(1) *Wholesale distributors.* The term ''wholesale distributors'' means persons who customarily resell to others who in turn resell.

(2) *Special dealer.* The term ''special dealer'' means a distributor of articles taxable under section 4121 (relating to electric, gas, and oil appliances) who does not maintain a sales force to resell the article whose constructive sale price is established under paragraph (c) of this section but relies on salesmen of the manufacturer, producer, or importer of the article for resale of the article to retailers.

(3) *Industry.* (i) The term ''industry'' as applied to any article generally means the specific category of articles listed in Chapter 32 of the Internal Revenue Code (other than combinations) that embraces the article for which a constructive sale price is to be determined under paragraph (c) of this section. For the rule applicable to combinations of two or more articles, see subdivision (iv) of this subparagraph.

(ii) The following are examples of categories of taxable articles which comprise separate industries:

(*a*) Taxable electric flatirons;

(*b*) Taxable electric, gas, and oil appliances of the type used for cooking,

warming, or keeping warm food or beverages for consumption on the premises;

(*c*) Taxable electric direct-motor and belt-driven fans and air circulators;

(*d*) Taxable electric, gas, and oil incinerator units and garbage disposal units;

(*e*) Taxable electric light bulbs and tubes;

(*f*) Taxable radio receiving sets;

(*g*) Taxable automobile radio receiving sets;

(*h*) Taxable radio and television components;

(*i*) Taxable musical instruments;

(*j*) Taxable fishing rods, creels, reels and artificial lures, baits, and flies;

(*k*) Taxable golf bags, balls and clubs;

(*l*) Taxable cameras;

(*m*) Taxable unexposed photographic film in rolls (including motion picture film);

(*n*) Taxable check writing, signing, cancelling, perforating, cutting, and dating machines, and other check protector machine devices;

(*o*) Taxable cash registers; and

(*p*) Taxable mechanical pencils, fountain pens and ball point pens.

(iii) With respect to the tax imposed by section 4061, the following categories of articles are to be considered separate industries:

(*a*) Taxable automobile trucks (consisting of automobile truck bodies and chassis);

(*b*) Taxable automobile buses (consisting of automobile bus bodies and chassis);

(*c*) Taxable truck and bus trailers and semitrailers (consisting of chassis and bodies of such trailers and semitrailers);

(*d*) Taxable tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer;

(*e*) All other taxable automobile chassis and bodies;

(*f*) Taxable trailer and semitrailer chassis and bodies suitable for use in connection with passenger automobiles; and

(*g*) Taxable automobile parts and accessories.

(iv) With respect to an article which is:

(*a*) Taxable as ''Combinations of household type refrigerators and quick-freeze units'' under section 4111,

(*b*) Taxable as ''Combinations of any of the foregoing'' under sections 4141 and 4191, or

(*c*) A combination, other than a combination referred to in (*a*) or (*b*) of this subdivision, of articles taxable under the same section or different sections of Chapter 32 of the Code.

The industry test required by paragraph (c)(2)(iii) of this section for such article shall be met if such test is met for the article or articles which comprise more than 50 percent in value of the combination. In case of a combination consisting of a taxable article and a nontaxable article, the category for the taxable article in the combination shall constitute the industry for purposes of paragraph (c)(2)(iii) of this section.

[T.D. 6355, 24 FR 311, Jan. 14, 1959]

PARTS 151–155 [RESERVED]

PART 156—EXCISE TAX ON GREENMAIL

Subpart A—Tax on Greenmail

Sec.
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156.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.
156.6696–1 Claims for credit or refund by tax return preparers.
156.7701–1 Tax return preparer.

AUTHORITY: 26 U.S.C. 6001, 6011, 6061, 6071, 6091, 6161, and 7805.

Section 156.6060–1 also issued under 26 U.S.C. 6060(a);

Section 156.6081–1 also issued under 26 U.S.C. 6081(a);

Section 156.6109–1 also issued under 26 U.S.C. 6109(a);

Section 156.6109–2 also issued under 26 U.S.C. 6109(a);

Section 156.6695–1 also issued under 26 U.S.C. 6695(b).

SOURCE: T.D. 8379, 56 FR 65685, Dec. 18, 1991, unless otherwise noted.

Subpart A—Tax on Greenmail

§ 156.5881–1 Imposition of excise tax on greenmail.

(a) *In general.* Section 5881 of the Code imposes a tax equal to 50 percent of the gain or other income realized by any person on the receipt of greenmail, whether or not the gain or other income is recognized.

(b) *Transactions occurring on or after March 31, 1988.* For transactions occurring on or after March 31, 1988, greenmail is defined as any consideration transferred by a corporation (or any person acting in concert with the corporation) to directly or indirectly acquire stock of the corporation from any shareholder if:

(1) The transferring shareholder has held the stock (as determined under section 1223) for less than two years before entering into the agreement to transfer the stock,

(2) The shareholder, any person acting in concert with the shareholder, or any person related to the shareholder or to a person acting in concert with the shareholder made or threatened to make a public tender offer for stock of the corporation at some time during the two-year period ending on the date of the acquisition of the stock by the corporation, and

(3) The acquisition is pursuant to an offer that was not made on the same terms to all shareholders.

(c) *Transactions occurring before March 31, 1988.* For transactions occurring before March 31, 1988, greenmail has the same meaning as in paragraph (b) of this section, except that it does not include any consideration transferred by any person acting in concert with the corporation described in that paragraph.

(d) *Effective date.* Generally, section 5881 of the Code applies to consideration received after December 22, 1987, in taxable years ending after that date. However, section 5881 does not apply to any acquisition of stock pursuant to a written binding contract in effect on December 15, 1987, and at all times thereafter before the acquisition.

Subpart B—Procedure and Administration

§ 156.6001–1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* Any person subject to tax under chapter 54 (Greenmail) of the Code shall keep such complete and detailed records as are sufficient to enable the district director to determine accurately the amount of liability under chapter 54.

(b) *Notice by district director requiring returns, statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not the person is liable for tax under chapter 54 of the Code.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or

employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

[T.D. 8379, 56 FR 65685, Dec. 18, 1991; 57 FR 5931, Feb. 18, 1992]

§ 156.6011–1 General requirement of return, statement, or list.

Every person liable for tax under section 5881 of the Code shall file a return with respect to the tax on the form prescribed by the Internal Revenue Service (Form 8725). Each such person shall include therein the information required by the form and the instructions issued with respect thereto.

§ 156.6060–1 Reporting requirements for tax return preparers.

(a) *In general.* A person that employs one or more tax return preparers to prepare a return or claim for refund under section 5881 of the Internal Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6061–1 Signing of returns and other documents.

Any return, statement, or other document required to be made with respect to a tax imposed by chapter 54 (Greenmail) of the Code or the regulations thereunder shall be signed by the person required to file the return, statement, or other document, or by the persons required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such return, statement, or document. An individual's signature on such a return, statement, or other document shall be prima facie evidence that the individual is authorized to sign the return, statement, or other document.

§ 156.6065–1 Verification of returns.

If a return, statement, or other document made under the provisions of chapter 54 (Greenmail) or of subtitle F of the Code, or the regulations thereunder with respect to any tax imposed by chapter 54, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of chapter 54 or of subtitle F of the Code, or the regulations thereunder with respect to any tax imposed by chapter 54 may be required to contain or be verified by written declaration that is made under the penalties of perjury.

§ 156.6071–1 Time for filing returns relating to greenmail.

(a) *In general.* Returns required by § 156.6011–1 (relating to liability for tax on greenmail under section 5881) shall be filed on or before the ninetieth day following receipt of any portion of the greenmail. Greenmail is considered to be received when gain or other income is realized, as determined according to the taxpayer's method of accounting, without regard to any provision of the Code providing for deferral of recognition.

(b) *Returns relating to greenmail received before the date these regulations become final.* Returns required by § 156.6011–1 that relate to greenmail received on or before December 18, 1991, shall be filed on or before March 18, 1992.

§ 156.6081–1 Automatic extension of time for filing a return due under chapter 54.

(a) *In general.* A taxpayer required to file a return on Form 8725, ''Excise Tax on Greenmail,'' will be allowed an automatic 6-month extension of time to file the return after the date prescribed for filing the return if the taxpayer files an application under this section in accordance with paragraph (b) of this section.

(b) *Requirements.* To satisfy this paragraph (b), a taxpayer must—

(1) Submit a complete application on Form 7004, ''Application for Automatic

Extension of Time to File Certain Business Income Tax, Information, and Other Returns,'' or in any other manner prescribed by the Commissioner;

(2) File the application on or before the date prescribed for filing the return with the Internal Revenue Service office designated in the application's instructions; and

(3) Remit the amount of the properly estimated unpaid tax liability on or before the date prescribed for payment.

(c) *No extension of time for the payment of tax*. An automatic extension of time for filing a return granted under paragraph (a) of this section will not extend the time for payment of any tax due on such return.

(d) *Termination of automatic extension*. The Commissioner may terminate an automatic extension at any time by mailing to the taxpayer a notice of termination at least 10 days prior to the termination date designated in such notice. The Commissioner must mail the notice of termination to the address shown on the Form 7004 or to the taxpayer's last known address. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter.

(e) *Penalties*. See section 6651 for failure to file or failure to pay the amount shown as tax on the return.

(f) *Effective/applicable dates*. This section is applicable for applications for an automatic extension of time to file a return due under chapter 54, filed after July 1, 2008.

[T.D. 9407, 73 FR 37370, July 1, 2008]

§ 156.6091–1 Place for filing chapter 54 (Greenmail) tax returns.

Except as provided in § 156.6091–2 (relating to exceptional cases):

(a) *Individuals, estates, and trusts*. In general, tax returns under chapter 54 of the Code of individuals, estates, and trusts shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the legal residence or the principal place of business of the person required to make the return.

(b) *Corporations*. In general, tax returns under chapter 54 of the Code of corporations shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the principal place of business or the principal office or agency of the corporation.

(c) *Partnerships*. In general, tax returns under chapter 54 of the Code of partnerships shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the principal place of business or the principal office or agency of the partnership.

(d) *Returns of taxpayers outside the United States*. The return of a person (other than a partnership or a corporation) outside the United States having no legal residence or principal place of business or agency in the United States, or the return of a partnership or a corporation having no principal place of business or principal office or agency in the United States, shall be filed with the Internal Revenue Service, Philadelphia, PA 19255, or as otherwise directed in the applicable forms and instructions.

(e) *Returns filed with service centers or by hand carrying*. Notwithstanding paragraph (a), (b), (c), or (d) of this section, unless a return is filed by hand carrying, whenever instructions applicable to tax returns under chapter 54 of the Code provide that the returns be filed with a service center, the returns must be so filed in accordance with the instructions. Returns that are filed by hand carrying shall be filed with any person assigned the responsibility to receive hand-carried returns in the local Internal Revenue Service office in accordance with paragraphs (a), (b), (c), or (d) of this section.

[T.D. 8379, 56 FR 65685, Dec. 18, 1991; 57 FR 5931, Feb. 18, 1992, as amended by T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 156.6091–2 Exceptional cases.

Notwithstanding the provisions of § 156.6091–1, the Commissioner may permit the filing of any tax return under chapter 54 (Greenmail) of the Code in any local Internal Revenue Service office.

[T.D. 8379, 56 FR 65685, Dec. 18, 1991, as amended by T.D. 9156, 69 FR 55747, Sept. 16, 2004]

§ 156.6107–1 Tax return preparer must furnish copy of return and claim for refund to taxpayer and must retain a copy or record.

(a) *In general.* A person who is a signing tax return preparer of any return or claim for refund of tax under section 5881 of the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the taxpayer and retain a completed copy or record in the manner stated in § 1.6107–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund.

(a) *In general.* Each tax return or claim for refund for tax under section 5881 of the Internal Revenue Code prepared by one or more signing tax return preparers must include the identifying number of the preparer required by § 1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in § 1.6109–2 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6151–1 Time and place for paying of tax shown on returns.

The tax under chapter 54 (Greenmail) of the Code shown on any return shall, without notice of assessment and demand, be paid to the internal revenue officer with whom the return is filed at the time and place for filing such return (determined without regard to any extension of time for filing the return). For provisions relating to the time and place for filing such return, see §§ 156.6071–1 and 156.6091–1. For provisions relating to the extension of time for paying the tax, see § 156.6161–1.

§ 156.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by chapter 54 (Greenmail) of the Code and shown or required to be shown on any return may be granted by the appropriate district director at the request of the taxpayer. The period of such extension shall not exceed 6 months from the date for payment of such tax.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by chapter 54 of the Code may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid. The extension may be for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand. In exceptional cases, a further extension for a period not in excess of 12 months may be granted. No extension of time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished.* The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof unless so specified in the extension.

(b) *Certain rules relating to extensions of time for paying income tax to apply.* The provisions of § 1.6161–1 (b), (c), and (d) of this chapter (relating to a requirement for undue hardship, to the application for extension, and to payment pursuant to an extension) shall apply to extensions of time for payment of the tax imposed by chapter 54 of the Code.

§ 156.6165–1 Bonds where time to pay tax or deficiency has been extended.

If an extension of time for payment is granted under section 6161 of the Code, the district director or the director of the service center may, if he deems it necessary, require a bond for the payment of the amount in respect to which the extension is granted in accordance with the terms of the extension. However, the bond shall not exceed double the amount with respect to which the extension is granted. For

provisions relating to form of bonds, see the regulations under section 7101 of the Code contained in part 301 of title 26 (Regulations on Procedure and Administration).

§ 156.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general.* For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund for tax under section 5881 of the Internal Revenue Code, see § 1.6694–1 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under section 5881 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under section 5881 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection when a tax return preparer who prepared a return or claim for refund for tax under section 5881 of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78461, Dec. 22, 2008]

§ 156.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under section 5881 of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 156.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules for claims for credit or refund by a tax return preparer who prepared a return or claim for refund for tax under section 5881 of the Internal Revenue Code, the rules

under §1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 156.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see §301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

PART 157—EXCISE TAX ON STRUCTURED SETTLEMENT FACTORING TRANSACTIONS

Subpart A—Tax on Structured Settlement Factoring Transactions

Sec.
157.5891–1 Imposition of excise tax on structured settlement factoring transactions.

Subpart B—Procedure and Administration

157.6001–1 Records, statements, and special returns.
157.6011–1 General requirement of return, statement, or list.
157.6060–1 Reporting requirements for tax return preparers.
157.6061–1 Signing of returns and other documents.
157.6065–1 Verification of returns.
157.6071–1 Time for filing returns.
157.6081–1 Automatic extension of time for filing a return due under chapter 55.
157.6091–1 Place for filing returns.
157.6107–1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.
157.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund.
157.6151–1 Time and place for paying of tax shown on returns.
157.6161–1 Extension of time for paying tax.
157.6165–1 Bonds where time to pay tax has been extended.
157.6694–1 Section 6694 penalties applicable to tax return preparer.
157.6694–2 Penalties for understatement due to an unreasonable position.
157.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.
157.6694–4 Extension of period of collection when preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.
157.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.
157.6696–1 Claims for credit or refund by tax return preparers.
157.7701–1 Tax return preparer.

AUTHORITY: 26 U.S.C. 7805.

Section 157.6001–1 also issued under 26 U.S.C. 6001;

Section 157.6011–1 also issued under 26 U.S.C. 6011;

Section 157.6061–1 also issued under 26 U.S.C. 6061;

Section 157.6071–1 also issued under 26 U.S.C. 6071;

Section 157.6081–1 also issued under 26 U.S.C. 6081(a);

Section 157.6091–1 also issued under 26 U.S.C. 6091;

Section 157.6060–1 also issued under 26 U.S.C. 6060(a);

Section 157.6109–1 also issued under 26 U.S.C. 6109(a);

Section 157.6109–2 also issued under 26 U.S.C. 6109(a);

Section 157.6161–1 also issued under 26 U.S.C. 6161;

Section 157.6695–1 also issued under 26 U.S.C. 6695(b).

SOURCE: T.D. 9134, 69 FR 41193, July 8, 2004, unless otherwise noted.

Subpart A—Tax on Structured Settlement Factoring Transactions

§ 157.5891–1 Imposition of excise tax on structured settlement factoring transactions.

(a) *In general.* Section 5891 imposes on any person who acquires, directly or indirectly, structured settlement payment rights in a structured settlement factoring transaction a tax equal to 40 percent of the factoring discount with respect to such factoring transaction.

(b) *Exceptions for certain approved transactions*—(1) *In general.* The excise tax shall not apply to a structured settlement factoring transaction if the transfer of structured settlement payment rights is approved in advance in a qualified order.

(2) *Qualified order dispositive.* A qualified order shall be treated as dispositive for purposes of this exception.

(c) *Definitions*—(1) *Applicable state statute* means—

(i) A statute that is enacted by the state in which the payee of the structured settlement is domiciled and provides for the entry of an order, judgment, or decree described in paragraph (c)(4)(i) of this section; or

(ii) If there is no such statute, a statute that—

(A) Is enacted by the state in which either the party to the structured settlement (including an assignee under a qualified assignment under section 130) or the person issuing the funding asset for the structured settlement is domiciled or has its principal place of business; and

(B) Provides for the entry of such an order, judgment, or decree.

(2) *Applicable state court* means, with respect to any applicable state statute, a court of the state that enacted such statute. If the payee of the structured settlement is not domiciled in the state that enacted the statute, the term also includes a court of the state in which the payee is domiciled.

(3) *Factoring discount* means an amount equal to the excess of—

(i) The aggregate undiscounted amount of structured settlement payments being acquired in the structured settlement factoring transaction; over

(ii) The total amount actually paid by the acquirer to the person from whom such structured settlement payments are acquired.

(4) *Qualified order* means a final order, judgment, or decree that—

(i) Finds that the transfer of structured settlement payment rights does not contravene any Federal or state statute, or the order of any court or responsible administrative authority, and is in the best interest of the payee, taking into account the welfare and support of the payee's dependents; and

(ii) Is issued under the authority of an applicable state statute by an applicable state court, or is issued by the responsible administrative authority (if any) which has exclusive jurisdiction over the underlying action or proceeding which was resolved by means of the structured settlement.

(5) *Responsible administrative authority* means the administrative authority that had jurisdiction over the underlying action or proceeding that was resolved by means of the structured settlement.

(6) *State* includes the Commonwealth of Puerto Rico and any possession of the United States.

(7) *Structured settlement* means an arrangement—

(i) That is established by—

(A) Suit or agreement for the periodic payment of damages excludable from the gross income of the recipient under section 104(a)(2); or

(B) Agreement for the periodic payment of compensation under any workers' compensation law excludable from the gross income of the recipient under section 104(a)(1); and

(ii) Under which the periodic payments are—

(A) Of the character described in section 130(c)(2)(A) and (B); and

(B) Payable by a person who is a party to the suit or agreement or to the workers' compensation claim or by a person who has assumed the liability for such periodic payments under a qualified assignment in accordance with section 130.

(8) *Structured settlement factoring transaction* means a transfer of structured settlement payment rights (including portions of structured settlement payments) made for consideration by means of sale, assignment, pledge, or other form of encumbrance or alienation for consideration other than—

(i) The creation or perfection of a security interest in structured settlement payment rights under a blanket security agreement entered into with an insured depository institution in the absence of any action to redirect the structured settlement payments to such institution (or agent or successor thereof) or otherwise to enforce such blanket security interest as against the structured settlement payment rights; or

(ii) A subsequent transfer of structured settlement payment rights acquired in a structured settlement factoring transaction.

(9) *Structured settlement payment rights* means rights to receive payments under a structured settlement.

(d) *Coordination with other provisions of the Internal Revenue Code*—(1) *In general.* If the applicable requirements of

sections 72, 104(a)(1), 104(a)(2), 130, and 461(h) were satisfied at the time the structured settlement involving structured settlement payment rights was entered into, the subsequent occurrence of a structured settlement factoring transaction shall not affect the application of the provisions of such sections to the parties to the structured settlement (including an assignee under a qualified assignment under section 130) in any taxable year.

(2) *No withholding of tax*. The provisions of section 3405 regarding withholding of tax shall not apply to the person making the payments in the event of a structured settlement factoring transaction.

(e) *Effective dates*. This section applies to structured settlement factoring transactions entered into on or after July 8, 2004. For structured settlement factoring transactions entered into before July 8, 2004, *see* § 157.5891–1T of this chapter (2003–1 C.B. 564. *See* § 601.601(d)(2) of this chapter.), as it appeared in the April 1, 2003, edition of 26 CFR part 157.

Subpart B—Procedure and Administration

§ 157.6001–1 Records, statements, and special returns.

(a) *In general*. Any person subject to tax under chapter 55 (Structured Settlement Factoring Transactions) of the Internal Revenue Code must keep such complete and detailed records as are sufficient to enable the Internal Revenue Service (IRS) to determine accurately the amount of liability under chapter 55.

(b) *Notice by the IRS requiring returns, statements, or the keeping of records*. The IRS may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the IRS to determine whether or not the person is liable for tax under chapter 55.

(c) *Retention of records*. The records required by this section must be kept at all times available for inspection by the IRS, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§ 157.6011–1 General requirement of return, statement, or list.

Every person liable for tax under section 5891 must file a return with respect to the tax in accordance with the forms and instructions provided by the Internal Revenue Service.

§ 157.6060–1 Reporting requirements for tax return preparers.

(a) *In general*. A person that employs one or more tax return preparers to prepare a return or claim for refund for tax under section 5891 of the Internal Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date*. This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6061–1 Signing of returns and other documents.

Any return, statement, or other document required to be made with respect to a tax imposed by chapter 55 (Structured Settlement Factoring Transactions) of the Internal Revenue Code or the regulations under chapter 55 must be signed by the person required to file the return, statement, or other document, or by the persons required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such return, statement, or document. An individual's signature on such return, statement, or other document shall be prima facie evidence that the individual is authorized to sign the return, statement, or other document.

§ 157.6065–1 Verification of returns.

If a return, statement, or other document made under the provisions of chapter 55 (Structured Settlement Factoring Transactions) or of subtitle F of the Internal Revenue Code, or the regulations under those provisions with respect to any tax imposed by chapter 55, or the form and instructions issued with respect to such return, statement, or other document, requires that it

shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of chapter 55 or subtitle F, or the regulations under those provisions, with respect to any tax imposed by chapter 55 may be required to contain or be verified by written declaration that it is made under the penalties of perjury.

§ 157.6071–1 Time for filing returns.

(a) *In general*. Except as provided in paragraph (b) of this section, returns required by § 157.6011–1 (relating to returns of tax with respect to structured settlement factoring transactions) must be filed on or before the ninetieth day following the receipt of structured settlement payment rights in a structured settlement factoring transaction.

(b) *Returns relating to structured settlement payment rights received before February 19, 2003*. Returns required by § 157.6011–1 that relate to structured settlement payment rights received on or before February 19, 2003, must be filed on or before May 20, 2003.

§ 157.6081–1 Automatic extension of time for filing a return due under chapter 55.

(a) *In general*. A taxpayer required to file a return on Form 8876, ''Excise Tax on Structured Settlement Factoring Transactions'', will be allowed an automatic 6-month extension of time to file the return after the date prescribed for filing the return if the taxpayer files an application under this section in accordance with paragraph (b) of this section.

(b) *Requirements*. To satisfy this paragraph (b), the taxpayer must—

(1) Submit a complete application on Form 7004, ''Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns,'' or in any other manner prescribed by the Commissioner;

(2) File the application on or before the date prescribed for filing the return with the Internal Revenue Service office designated in the application's instructions; and

(3) Remit the amount of the properly estimated unpaid tax liability on or before the date prescribed for payment.

(c) *No extension of time for the payment of tax*. An automatic extension of time for filing a return granted under paragraph (a) of this section will not extend the time for payment of any tax due on such return.

(d) *Termination of automatic extension*. The Commissioner may terminate an automatic extension at any time by mailing to the taxpayer a notice of termination at least 10 days prior to the termination date designated in such notice. The Commissioner must mail the notice of termination to the address shown on the Form 7004 or to the taxpayer's last known address. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter.

(e) *Penalties*. See section 6651 for failure to file or failure to pay the amount shown as tax on the return.

(f) *Effective/applicability dates*. This section is applicable for applications for an automatic extension of time to file a return due under chapter 55, filed after July 1, 2008.

[T.D. 9407, 73 FR 37370, July 1, 2008]

§ 157.6091–1 Place for filing returns.

The return required by § 157.6011–1 (relating to returns of tax with respect to structured settlement factoring transactions) must be filed at the place specified in the forms and instructions provided by the Internal Revenue Service.

§ 157.6107–1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.

(a) *In general*. A person who is a signing tax return preparer of any return or claim for refund of tax under section 5891 of the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the taxpayer and retain a completed copy or record in the manner stated in § 1.6107–1 of this chapter.

(b) *Effective/applicability date*. This section is applicable to returns and

claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund.

(a) *In general*. Each tax return or claim for refund for tax under section 5891 of the Internal Revenue Code prepared by one or more signing tax return preparers must include the identifying number of the preparer required by § 1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in § 1.6109–2 of this chapter.

(b) *Effective/applicability date*. Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6151–1 Time and place for paying of tax shown on returns.

The tax under chapter 55 (Structured Settlement Factoring Transactions) of the Internal Revenue Code shown on any return must, without assessment or notice and demand, be paid at the time and place specified in the forms and instructions provided by the Internal Revenue Service. For provisions relating to the time and place for filing such return, see § 157.6071–1 and § 157.6091–1. For provisions relating to the extension of time for paying the tax, see § 157.6161–1.

§ 157.6161–1 Extension of time for paying tax.

(a) *In general*—(1) *Tax shown or required to be shown on return*. The Internal Revenue Service may, at the request of the taxpayer, grant a reasonable extension of time for payment of the amount of any tax imposed by chapter 55 (Structured Settlement Factoring Transactions) of the Internal Revenue Code and shown or required to be shown on any return. The period of such extension shall not exceed 6 months from the date fixed for payment of such tax, except that in the case of a taxpayer that is abroad, such extension may exceed 6 months.

(2) *Extension of time for filing distinguished*. The granting of an extension of time for filing a return does not extend the time for the payment of the tax or any part thereof unless so specified in the extension.

(b) *Certain rules relating to extension of time for paying income tax to apply*. The provisions of § 1.6161–1(b), (c), and (d) of this chapter (relating to a requirement for undue hardship, to the application for extension, and to payment pursuant to an extension) shall apply to extensions of time for payment of the tax imposed by chapter 55 of the Code.

§ 157.6165–1 Bonds where time to pay tax has been extended.

If an extension of time for payment is granted under section 6161, the Internal Revenue Service may, if it deems necessary, require a bond for the payment, in accordance with the terms of the extension, of the amount with respect to which the extension is granted. However, the bond shall not exceed double the amount with respect to which the extension is granted. For provisions relating to the form of bonds, see the regulations under section 7101 contained in part 301 (Regulations on Procedure and Administration) of this chapter.

§ 157.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general*. For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund for tax under section 5891 of the Internal Revenue Code see § 1.6694–1 of this chapter.

(b) *Effective/applicability date*. Paragraph (a) of this section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general*. A person who is a tax return preparer of any return or claim for refund of tax under section 5891 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date*. This section is applicable to returns and

claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under section 5891 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6694–4 Extension of period of collection when preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection when a tax return preparer who prepared a return or claim for refund for tax under section 5891 of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78462, Dec. 22, 2008]

§ 157.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under section 5891 of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78463, Dec. 22, 2008]

§ 157.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules for claims for credit or refund by a tax return preparer who prepared a return or claim for refund for tax under section 5891 of the Internal Revenue Code, the rules under § 1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78463, Dec. 22, 2008]

§ 157.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see § 301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78463, Dec. 22, 2008]

PARTS 158–169 [RESERVED]

SUBCHAPTER E [RESERVED]

PARTS 170–299 [RESERVED]