

correctly, record "Amendment A" on the bottle's label and on the Equipment Log Card (FME) of the bottle, close the sliding cowling, and remove the access equipment.

(2) If the percussion heads and the attachment cartridges are not connected to the bottle correctly, reconfigure each bottle in accordance with the Accomplishment Instructions, paragraphs 2.B.4. through 2.B.4.4., of the Telex.

(b) Before installing, inspect any spare bottle to ensure that the yellow percussion head is located below the pressure gage and that the gray percussion head is located opposite the pressure gage.

(1) If the percussion heads are properly located, record "Amendment A" on the bottle's label and on the FME of the bottle.

(2) If the percussion heads are not located properly, loosen the union nuts; appropriately interchange the percussion heads, tighten the union nuts by hand, and record "Amendment A" on the label and on the FME of the bottle.

(c) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Regulations Group, Rotorcraft Directorate, FAA. Operators shall submit their requests through an FAA Principal Maintenance Inspector, who may concur or comment and then send it to the Manager, Regulations Group.

**Note 3:** Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Regulations Group.

(d) Special flight permits may be issued in accordance with 14 CFR 21.197 and 21.199 to operate the helicopter to a location where the requirements of this AD can be accomplished.

(e) The inspections and modifications shall be done in accordance with the Accomplishment Instructions, paragraphs 2.B.1. through 2.B.2.2., and paragraphs 2.B.4 through 2.B.4.4., of Eurocopter France Alert Telex No. 26.00.12, dated October 3, 2001. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. Copies may be obtained from American Eurocopter Corporation, 2701 Forum Drive, Grand Prairie, Texas 75053-4005, telephone (972) 641-3460, fax (972) 641-3527. Copies may be inspected at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.

(f) This amendment becomes effective on June 27, 2002.

**Note 4:** The subject of this AD is addressed in Direction Generale De L'Aviation Civile (France) AD T2001-471-020(A), dated October 5, 2001.

Issued in Fort Worth, Texas, on May 31, 2002.

**David A. Downey,**

Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 02-14568 Filed 6-11-02; 8:45 am]

**BILLING CODE 4910-13-P**

## DEPARTMENT OF TRANSPORTATION

### Federal Highway Administration

#### 23 CFR Part 172

[FHWA Docket No. FHWA-98-4350]

RIN 2125-AE45

#### Administration of Engineering and Design Related Services Contracts

**AGENCY:** Federal Highway Administration (FHWA), DOT.

**ACTION:** Final rule.

**SUMMARY:** This document revises the regulation on the administration of engineering and design related services contracts in order to establish procedures to be followed when using Federal-aid highway funds for the procurement of engineering and design related services, materials, equipment, or supplies. The regulation describes procurement methods contracting agencies are to use when acquiring these services or related items. This rule implements 23 U.S.C. 112(b), as amended, by requiring States to award Federal-aid highway engineering and design service contracts: In accordance with the provisions of title IX of the Federal Property and Administrative Services Act of 1949, by use of equivalent State qualifications-based procedures, or unless a State has previously established by statute a formal procurement procedure for engineering and design related services prior to June 9, 1998. This regulation does not apply to design-build contracts, which will be covered in another regulation.

**DATES:** This rule is effective July 12, 2002.

**FOR FURTHER INFORMATION CONTACT:** Mr. Gary E. Moss, Office of Program Administration, (HIPA-10), (202) 366-4654, or Mr. Steven Rochlis, Office of the Chief Counsel, (HCC-30), (202) 366-1395, FHWA, 400 Seventh Street, SW., Washington, DC 20590. Office hours are from 7:45 a.m. to 4:15 p.m., e.t., Monday through Friday, except Federal holidays.

#### SUPPLEMENTARY INFORMATION:

##### Electronic Access

Internet users may access all comments received by the U.S. DOT Docket Facility, Room PL-401, by using the URL: <http://dms.dot.gov>. It is available 24 hours each day, 365 days each year. Please follow the instructions online for more information and help.

An electronic copy of this document may be downloaded by using a computer, modem and suitable communications software from the

Government Printing Office's Electronic Bulletin Board at (202) 512-1661.

Internet users may reach the Office of the Federal Register's home page at <http://www.nara.gov/fedreg> and the Government Printing Office's web site at: <http://www.access.gpo.gov/nara>.

##### Background

The FHWA issued a notice of proposed rulemaking (NPRM) on July 18, 2000, at 65 FR 44486. Comments were received from 12 State DOTs, two companies, and one organization. The regulation on the administration of engineering and design related service contracts, 23 CFR part 172, draws its authority from 23 U.S.C. 112. Title 23, U.S.C., section 112 references the provisions of title IX of the Federal Property and Administrative Services Act of 1949 (Public Law 92-582, 86 Stat. 1278 (1972); 40 U.S.C. 541, *et seq.*) which provides the qualifications-based procedures to be followed for the selection of engineering and design related services. Section 307 of the National Highway System Designation Act of 1995 (NHS Act), Public Law 104-59, 109 Stat. 568, modified 23 U.S.C. 112 by requiring grantees of Federal-aid highway funds to accept indirect cost rates for architectural and engineering firms as long as these rates are established in accordance with the Federal Acquisition Regulations (FAR) (Title 48, Code of Federal Regulations) and these rates are accepted by a cognizant Federal or State agency if such rates are not under dispute. The law also specifies that once a firm's indirect cost rate is accepted, the grantee shall apply those indirect cost rates for the purposes of contract estimation, negotiation, administration, reporting, and contract payment. The NHS Act also provided a period of time in which State Departments of Transportation (State DOTs) could adopt statutes to allow use of alternate State procedures other than those provided for in the NHS Act.

Section 1205 of the Transportation Equity Act for the 21st Century (TEA-21), Public Law 105-178, 112 Stat. 107 (1998), further modified 23 U.S.C. 112(b) by removing the provision allowing State DOTs to adopt alternate procedures for the procurement of design and engineering consultants.

The changes made to 23 U.S.C. 112(b) by these two laws, as well as provisions in 23 U.S.C. 106(c) relating to the assumption by the State of responsibilities of the Secretary for project design and construction, require the FHWA to modify 23 CFR part 172, subpart A—Procurement Procedures. In addition, the FHWA adds several new

terms to the definition section to clarify existing terms used in the regulation.

The small purchase procedures section is revised by raising the maximum value for small purchases from \$25,000 to the value allowed in 41 U.S.C. 403(11), which is currently \$100,000.

The references to Certification Acceptance (CA), and § 172.15, Alternate Procedures, which were incorporated into 23 CFR part 172 to implement Certification Acceptance, are removed since Certification Acceptance was repealed by section 1601 of the TEA-21.

Reference to the Secondary Road Plan (SRP) and the Combined Road Plan (CRP) demonstration project, are removed since these programs are no longer being funded.

### Comments on Proposed Regulation

#### 172.1 Purpose and Applicability

The Michigan DOT requested that a reference be made to 41 U.S.C. Subchapter IV, Procurement Provisions, after the reference to the common grant rule found at 49 CFR part 18. Title 41, U.S.C., Subchapter IV, refers to contracts made directly by the United States Government and does not directly apply to grants to States and Counties, therefore, this provision was not incorporated into the final rule.

#### Section 172.3 Definitions

The Texas DOT requested that the term "private sector engineer and design firms" be removed from the definition section since the term is not used in the regulation. The FHWA agrees with the comment and the regulation has been modified accordingly.

Several comments requested the retention of definitions for "fixed fee" and "prenegotiation audit." Although still allowed, the regulation no longer specifies requirements for the use of "fixed fee" contracts or the use of a "prenegotiation audit," but instead refers to State procedures. Since these terms are no longer used in the final rule, they were removed.

The New York DOT suggested that in the definition of "cognizant agency," the term "State agency" is too broad and that the term "State Highway/Transportation Agency" would be preferred. The generic definition of "cognizant agency" is "Federal or State agency." Some States may have audit divisions that are not part of the State Highway/Transportation Agency, therefore the FHWA prefers a broader concept.

Several commenters requested that the definition of "cognizant agency" as

well as the procedure to get a cognizant agency audit should be set forth in greater detail in the regulation. Many commenters suggested that the FHWA should adopt the procedure and definition approved by the American Association of State Highway and Transportation Officials (AASHTO) Audit Subcommittee. The AASHTO Audit Subcommittee stated the following:

A "cognizant agency" is any one of the following:

- Federal Agency
- The Home State (*i.e.*, State where the firm's accounting and financial records are located)
- A Non-Home State to whom the Home State has transferred cognizance in writing for the particular indirect cost audit of a firm.

Cognizant audit is achieved by any one of the following methods:

- A Cognizant Agency performs or directs the work of a Certified Public Accountant (CPA) who performs the indirect cost audit.
- A Non-Home State auditor or CPA working under the State's direction issue an audit report and the Home State issues a letter of concurrence. If the Home State does not accept the audit of another State, the Home State will have 180 days from receipt to issue a cognizant audit; otherwise, the Non-Home State audit report will be cognizant for the 1 year applicable accounting period.
- An indirect cost audit performed by a CPA hired by the firm will become a cognizant audit if one of the following conditions is met:

(a) The Home State reviews the CPA's working papers and the Home State issues a letter of concurrence with the audit report.

(b) A Non-Home State reviews the CPA's working papers and issues a letter of concurrence with the CPA's report which is then accepted by the Home State. If the Home State does not accept the Non-Home State review, the Home State will have 180 days from receipt to complete a review of the CPA audit report and either concur with it, modify it, or reject it due to a material error requiring re-submittal; otherwise the CPA audit report with which the Non-Home State has concurred will be cognizant for the 1 year applicable accounting period.

The FHWA believes that the AASHTO Audit Subcommittee procedures have merit, but the FHWA has determined that these procedures should be thoroughly tested under implementing guidance to be disseminated to the States. Therefore the Audit Subcommittee's approved definition

and procedure is not included in the final regulation.

The Oregon DOT was concerned that the one year term for overhead rates was not defined. To assist in the use of this regulation a new definition was added based on material from the FAR. The new definition defines one year applicable accounting period as the annual accounting period for which financial statements are regularly prepared for the consultant.

Several commenters recommended that the term "audit" be defined in the regulation. Some commenters suggested using the definition: "An audit performed in accordance with Governments Auditing Standards promulgated by the United States General Accounting Office." The FHWA added a definition of the term audit to the final rule.

#### Section 172.5 Methods of Procurement

##### Section 172.5(a)(1) Competitive Negotiations

The Wisconsin DOT was concerned that a key point of the Brooks Architect-Engineers Act (40 U.S.C. 541-544) was not included in the regulation, *i.e.*, price is not to be a factor in the analysis and selection phase. The FHWA agrees that this is a key point in the Brooks Bill procedure and, as such, is already covered by the Brooks Bill requirements. Due to its importance, and to be clear on this point, we have added a sentence in § 172.5(a)(1) restating that price is not to be a factor in the analysis and selection phase.

TransTech Management, Inc. commented on how various States have experimented with alternative selection practices, one being the best value approach, and stated:

The premise behind this approach is that the consultants are selected in a two-tiered selection process that considers the value of a project without compromising quality or safety. In this approach the U.S. DOT identifies a short list of qualified firms, then the final selection is based on a set of criteria that includes qualifications, cost, and possibly other factors.

TransTech Management also suggested that best value be allowed for design consultant selection.

The Texas Transportation Commission also recommends a best value approach be taken rather than a strictly qualifications based selection process in the Brooks Bill. In response to these comments, the FHWA maintains that 23 U.S.C. 112 requires that the Brooks Bill method be used in the selection of design consultants when Federal-aid funds are used, except if alternate procedures have been adopted

by the State prior to enactment of the TEA-21. Accordingly, no change was made to the regulation, however the Secretary has authority to conduct innovative contracting research under 23 U.S.C. 502(a) on an experimental basis.

The New Jersey DOT recommended that "the rules should provide the flexibility that would allow competitive bids on certain types of fixed scope projects." The FHWA has allowed a simplified small purchases procurement procedure which provides substantial flexibility to the State. Nevertheless, for procurement over the small procurement threshold, the Brooks Act method is required by law, except if a State has adopted an alternative procedure enacted by the State prior to the enactment of the TEA-21, therefore, no change was made in the regulation.

The Michigan DOT was concerned that a cost analysis was not specifically required for competitive and non-competitive purchase procedures. For competitive procedures we require the Brooks Act requirements or equivalent State qualifications based procedures unless a formal statutory procedure was adopted by State statute prior to enactment of the TEA-21. The Brooks Act requires that the value of services to be rendered as well as the scope, complexity, and professional nature be considered in the negotiations. The FHWA believes that these requirements are sufficiently adequate for competitive purchase procedures. Non-competitive procurement procedures are generally an exception to competitive procurement procedures for Federal-aid highway projects and will continue to require review and approval by the FHWA before this procedure may be used. This review may include a cost analysis as well as a review of other supporting material submitted by the State before approval is obtained. Based on the above discussion, the FHWA believes that the rule adequately covers the concerns expressed in the comment.

The Michigan DOT requested that we add a section for fixed fees. Its comment states: "The determination of the Fixed Fee shall take into account the size, complexity, duration and degree of risk involved in the work and shall otherwise comply with 41 U.S.C. 254. The establishment of the fixed fee shall be project specific." The FHWA believes that the Brooks Act procedures that require the value of services to be rendered, the scope, the complexity, and the professional nature be considered in the negotiations addresses this issue for fixed fees used in competitive purchase procedures. The material in 41 U.S.C. 254 is intended for

Federal contracts rather than purchases by grantees using Federal assistance monies, therefore the FHWA did not add the requested reference to 41 U.S.C. 254.

#### *Section 172.5(a)(2) Small Purchase*

The New Jersey DOT suggested that "consideration should be given to raising the \$100,000 simplified acquisition threshold to \$125,000 to allow for inflation." The FHWA intends to follow the law for small purchase procurement found in 41 U.S.C. 403(11), which currently provides that \$100,000 is the maximum amount for small purchase procurement. However, the FHWA did revise the proposed regulation to reference the simplified acquisition threshold in 41 U.S.C. 403(11) rather than just listing the current \$100,000 amount. When the amount is revised in 41 U.S.C. 403(11), as it has been in the past, the simplified acquisition threshold in the final rule will also automatically reflect that new limit.

The Wisconsin DOT expressed concern with how the Brooks Act will apply to small purchase procedures. The previous regulation allowed contractors to use small purchase procedures in 23 CFR 172.7(b). The FHWA is continuing this practice by allowing relatively simple and informal procurement methods for small purchase design contracts where an adequate number of qualified sources are reviewed, as stated in 49 CFR 18.36 of the common grant rule. Also, the State's own procedures for small purchases where it uses with its own funds may be used for federally funded projects in accordance with 49 CFR 18.36 and 49 CFR 18.37 where the total contract amount including contract amendments do not exceed the small purchase threshold amount in 41 U.S.C. 403(11).

The Oregon DOT expressed concern regarding how the FAR audit requirements would apply for small purchase procedures. The FHWA's interpretation is that since small purchase threshold contracts may follow a simplified acquisition consistent with 49 CFR part 18, the FAR audit requirements of the final rule at 23 CFR 172.7(a) and (b) are not required to be applied to small purchase procedures. If the audits required by 23 CFR 172(a) and (b) are readily available they should be used. In the final rule, 23 CFR 172.7(e) provides that the States are responsible to reasonably assure that proper recordkeeping and accounting procedures are followed.

#### *Section 172.5(a)(4) State Statutory Procedures*

A comment from the HNTB Corporation questioned the use of the TEA-21 enactment date of June 9, 1998, throughout the regulation rather than the date of one year after the enactment of the NHS Act of November 28, 1995, to determine when a State could no longer enact legislation allowing it to adopt an alternate procedure whereby the subparagraphs added by section 307 of the NHS Act did not apply.

The NHS Act added subsections (b)(2) (C) through (G) to 23 U.S.C. 112 which included single audit requirements and provided that indirect cost rates shall not be limited by administrative or de facto ceilings. After the NHS Act was passed, a State had one year or a full State legislative cycle to enact laws allowing a State to adopt an alternate procedure. However, until the TEA-21 was enacted, States were free to adopt by statute a formal procedure for the procurement of design services which differed from Brooks Act procurement under 23 U.S.C. 112(b)(2)(B).

The FHWA's analysis of the statutory history of 23 U.S.C. 112 is that prior to the enactment of TEA-21, the Congress permitted a State to enact by State statute an alternate procurement procedure that was different from the requirements set forth in the NHS Act; therefore, the TEA-21 enactment date of June 9, 1998, is the correct date to use in the regulation. Nevertheless, the mere fact that a State adopted a formal statutory procedure for procurement of Architectural and Engineering services prior to enactment of TEA-21 does not permit a State to establish a ceiling on overhead rates where such statute did not address overhead ceiling rates.

#### *Section 172.7 Audits*

##### *Section 172.7(a) Performance of Audits*

Several commenters were concerned about the scope of the FAR audit requirements in § 172.7(a) and the hardships that States may experience from the requirements of numerous audits on contracts and subcontracts. Although the law requires that all contracts and subcontracts procured in accordance with 23 U.S.C. 112(b)(2)(C) be audited in compliance with cost principles contained in the part 31 of the FAR, the FHWA has determined that the State should determine the scope of those audits in their own procedures. The FHWA modified § 172.7 of the final rule to reflect the States' responsibility. The section now says: "When State procedures call for audits of contracts or subcontracts for engineering design

services, the audit shall test compliance with the requirements of the cost principles contained in the Federal Acquisition Regulations provided in 48 CFR part 31." Additionally, in many cases consultants selected by the Brooks Act procedure hire other consultants for small specialty jobs with State approval. Since these small subconsultant contracts were not procured in accordance with 23 U.S.C. 112(b)(2)(A), the audit requirements of this section would not apply.

The Oregon DOT, along with others, commented that 48 CFR part 31 (FAR 31) does not provide enough guidance. It is not the intent of this regulation to clarify the audit procedures in the FAR. However, additional guidance on the FAR may be obtained at the following internet site <http://www.arnet.gov>.

The Oregon DOT also commented that in § 172.7(a), audits are performed to standards rather than to principles. The Oregon DOT comment states: "This clause requires that audits comply with the cost principals contained in the FARs. Audits comply with audit standards rather than cost principles. Audits, while complying with audit standards, determine the level at which costs comply with cost principles. Changing the wording to read, '\* \* \* the audit shall determine compliance with the cost principles \* \* \*' (or some similar wording) would correct this discrepancy." The FHWA agrees with the Oregon DOT's comment and has made minor wording changes in the regulation to reflect that audits are performed "to test" compliance with the cost principles rather than "to" compliance with the cost principles.

#### *Section 172.7(b) Audits for Indirect Cost Rate*

The Oregon DOT was concerned that the FHWA has misinterpreted the requirements of section 307 of the NHS Act, specifically, 23 U.S.C. 112(b)(2)(D) and (E) and believes that the requirements for accepting the indirect cost rates fall on the consultant rather than on the contracting agency.

The following language from the conference report for the NHS Act (H.R. Conference Report No. 104-345, at 82 (1995)) which quotes from identical sections in the House (H.R. Rep. No. 104-246, (1995)) and Senate report (S. Rep. No. 104-86, (1995)) clarifies the meaning of the statute:

The recipient of Federal funds must accept and use indirect cost rates established by a government agency in accordance with Federal Acquisition Regulations for one-year applicable accounting periods in estimating, negotiating, and administering contracts. Recipients must notify affected firms before

requesting or using the cost and rate data and must keep the information confidential.

Based on the legislative history of this provision it is clear that the government agency, as the recipient of Federal funds, must notify the firms of cost data used and the government must establish the overhead rates. Therefore, no change was made to the regulation.

Several commenters were concerned about the requirements that the audit for the overhead rate could last for only one year. The Texas DOT commented that it does not believe it would be prudent to require an audit each year for a multi-year consulting contract if the audited indirect rate is acceptable to both contracting parties at the time of contract negotiation and execution. The FAR in 48 CFR 31.203(e) states that "\* \* \*, the base period for allocating indirect costs will normally be the contractor's fiscal year\* \* \*. When a contract is performed over an extended period, as many base periods shall be used as are required to represent the period of contract performance."

The guidance in the FAR would require the use of several base periods for a contract that is longer than one year. The language in 49 CFR 18.36(a) requires the use of State procedures in the administration of contracts with Federal grant funds, provided it does not conflict with Federal statutes. The FHWA agrees that it is reasonable to allow an audit for overhead rates to be valid for contracts longer than a year provided the consultant and the State agree to such a longer period. The final rule requires the consultant's indirect cost rates for its one-year applicable accounting period to be applied to the contract, however, once an indirect cost rate is established for a contract it may be extended beyond the one year applicable accounting period provided all concerned parties agree. Additionally, the final rule states that an agreement to the extension of the one-year applicable period shall not be a condition of contract award.

The Wisconsin DOT expressed concern that a State could not accept a lower overhead rate freely offered by a consultant firm. The Wisconsin DOT believes the proposed rule should be modified to make it clear that contracting agencies are not prohibited from using indirect cost rates which are unilaterally reduced by consultants. It believes that the intent of the law is to prevent contracting agencies from establishing ceilings on indirect cost rates, not to prevent firms from offering cost reductions. Furthermore, Wisconsin DOT states that occasionally firms will experience swings in their

business cycles which could result in high cost rates preventing them from being able to negotiate a reasonable total cost on their contract.

The FHWA agrees there are many reasons why an overhead rate for a firm may be unusually high for a short period of time. In such cases, a firm may believe that it would be in its best interest to offer a lower rate. The FHWA agrees that a consultant should be free to offer a lower overhead rate than the one determined by a cognizant Federal or State government agency, and that the contracting agency should be free to accept it provided such rate is offered voluntarily by the consultant. Under no circumstances, however, shall a contracting agency require a lowering of the overhead rate. We have added language to § 172.7(b) to address this comment.

There were several comments concerning the procedure used to arrive at a cognizant agency audit. Many comments requested that the procedure passed by the AASHTO Subcommittee on Audits, in conjunction with the American Consultant Engineers Council (ACEC), be used. The FHWA issued an interim procedure to obtain a cognizant agency audit on December 10, 1997, in the form of a question and answer memorandum which can be viewed at the FHWA web site at: <http://www.fhwa.dot.gov/programadmin/consultant.html>. The FHWA believes that the AASHTO Audit Subcommittee procedures have merit, but the FHWA has determined that these procedures should be thoroughly tested under implementing guidance to be disseminated to the States. Therefore the Audit Subcommittee's proposed definition and procedure is not included in the final regulation.

#### *Section 172.7(c) Disputed Audits*

The FHWA received several comments raising a concern that disputed audits were not well defined. The FHWA clarifies § 172.7(c) of the final rule to address these comments in § 172.7(c) as follows: "Only the consultant and the parties involved in performing the indirect cost audit may dispute the established indirect cost rate. If an error is discovered in the established indirect cost rate, the rate may be disputed by any prospective user."

#### *Section 172.7(d) Prenotification; Confidentiality of Data*

The Wisconsin DOT was concerned about with whom the State may share indirect cost and rate data. The Wisconsin DOT believes that the requirement for permission only applies

exclusively to the release of information to other firms and government agencies. Request for information from the press or ordinary citizens will be in accordance with State statutes.

The FHWA determination is that 23 U.S.C. 112(b)(2)(F) allows States to share audit information about a consultant with other recipients (States) and subrecipients of Federal-aid highway funds. States and subrecipients are only required to notify the consultant when such information is used or exchanged with another State or subrecipient to assist a State or subrecipient in complying with the State or subrecipient's acceptance of a consultant's overhead rates pursuant to 23 U.S.C. 112 and this regulation.

However when such audit information is sought by a firm or a government agency (when the government agency is seeking the information for a purpose unrelated to compliance with this regulation), the cost data shall not be provided except by written permission of the audited firm. Moreover, as pointed out by the Wisconsin DOT, the plain language of the law did not exclude ordinary citizens or the press from obtaining this data. The FHWA's position concerning requests from the press or private citizens for this data is that State and Federal information accessibility statutes, as applicable, will control such release consistent with 23 U.S.C. 112(b)(2)(F) which provides: "If prohibited by law, such cost and rate data shall not be disclosed under any circumstances." The regulation was modified at § 172.7(d) to address this issue by adding language that prohibits the release of this information if prohibited by law; however, should a release be required by law, or court order, the final rule states that such release shall make note of the confidential nature of the data.

*Section 172.9 Approvals*

*Section 172.9(a) Written Procedures*

The Texas DOT was concerned that the FHWA division offices were going to review all the county and city procedures for subgrants that the State may issue. The Texas DOT commented that it appears that the FHWA is assuming responsibility for approving all local governmental entity contracting procedures and revisions for federally funded engineering and design services. In Texas alone, there are 254 counties that have adopted various procedures that are subject to review by TxDOT through oversight agreement with the FHWA and the State's statutes.

It is not the FHWA's intent to review all county and city procedures for State subgrants. Although 49 CFR 18.37 addresses subgrants and requires the State ensure that subgrants meet State and Federal requirements, the FHWA felt it was necessary to cover the topic in the final rule. The FHWA added a new sentence to § 172.1 which states, "Recipients of Federal funds shall ensure that their subrecipients comply with Federal regulations" and made minor revisions to § 172.9(a) of the final rule.

For ease of reference the following distribution table is provided:

Old Section	New Section
172.1(a) .....	172.1 Revised.
172.1(b) .....	172.1 Revised and 172.5(a)(4) Revised.
172.3 .....	172.3 Revised.
Audit .....	Added.
Cognizant agency .....	Added.
Competitive negotiation .....	Revised.
Contract modification .....	Removed.
Extra work .....	Removed.
Fixed fee .....	Removed.
One-year applicability accounting period .....	Added.
Prenegotiation audit .....	Removed.
Private sector engineering and design firms .....	Removed.
Scope of work .....	Removed.
172.5(a) .....	172.9(d) Revised.
172.5(b) .....	172.9(a). Revised.
172.5(c) .....	Removed.
172.5(d) .....	172.1 Revised.
172.5(e) .....	172.5(b) Revised.
172.5(f) .....	172.9(b) Revised.
172.7 introductory paragraph .....	172.5 introductory paragraph revised and 172.5(a)(1) Revised.
172.7(a) .....	172.5(a)(1) Revised.
172.7(a)(3)(ii)(B) .....	172.5(a)(4) Revised.
172.7(b) .....	172.5(a)(2) Revised.
172.7(c) .....	172.5(a)(3) Revised.
172.7(c)(1) .....	172.5(a)(3) Revised.
172.7(c)(1)(i) .....	172.5(a)(3)(i). No change.
172.7(c)(1)(ii) .....	172.5(a)(3)(ii). No change.
172.7(c)(1)(iii) .....	172.5(a)(3)(iii). No change.
172.7(c)(2) .....	Removed.
172.9(a) .....	172.7(a) Revised.
None .....	172.7(b) Added.
None .....	172.7(c) Added.
None .....	172.7(d) Added.
172.9(b) .....	Removed.
172.9(c)2 .....	172.5(c) Revised.
172.9(c)(1), (3), (4) ...	Removed.
172.9(d) .....	Removed.
None .....	172.9(b) and (c) Added.
172.11 .....	Removed.
172.13 .....	Removed.
172.15 .....	Removed.

Old Section	New Section
172.21, 172.23 and 172.25.	Removed.

**Section-by-Section Analysis**

*Section 172.1 Purpose and Applicability*

The statement of purpose and applicability was revised to remove the references to the Certification Acceptance Plans that were repealed by the TEA-21; to remove an obsolete reference to the Secondary Road Plans; and to remove the reference to Combined Road Plans because the Secondary and Combined Road programs are no longer being funded. A new sentence is added requiring recipients of Federal funds to ensure that their subrecipients comply with Federal regulations. Additionally, paragraph (b) was revised to limit the use of State statutes for an alternate procedure to those enacted into law before June 9, 1998 (the date the TEA-21 was enacted), and redesignated as § 172.5(a)(4).

*Section 172.3 Definitions*

The term "audit" is added to the list of definitions as a review to test the contractor's compliance with the requirements of cost principles contained in 48 CFR part 31.

The term "cognizant agency" is added to the list of definitions and is defined as any Federal or State agency that has conducted and issued an audit report of the consultant's indirect cost rate that has been developed in accordance with the requirements of the cost principles contained in 48 CFR part 31.

The term "One-year applicable accounting period" is added to the list of definitions and is defined as the accounting period for which annual financial statements are regularly prepared for the consultant.

The term "competitive negotiation" is revised to permit the use of procurement procedures enacted into State law prior to the enactment of TEA-21 (June 9, 1998).

The terms "contract modification," "extra work," "fixed fee," "prenegotiation audit," "scope of work" and "private sector engineering and design firms" were removed since they are not used in the new regulation.

*Section 172.5 General Principles*

This section is removed from the regulation. Most of the material was reorganized and moved to other sections. The provisions of paragraph (a), the consultant services in management

roles, are revised and moved to § 172.9(d).

Paragraph (b), written procedures, is redesignated as § 172.9(a).

The provisions of paragraph (c), Prenegotiation audits is removed. The FHWA received several comments expressing concern over the removal of the requirements for prenegotiation audits. These comments indicate that prenegotiation reviews may not be allowed or not be eligible for Federal-aid funds which may prevent the State from being able to assure that the consultant has the proper procedures and an adequate accounting system to meet Federal requirements. The FHWA never intended to prevent the performance of prenegotiation audits and reviews, but wanted to give the States greater control over when they are used. With the required use of cognizant audits for overhead rates, the need for prenegotiation audits and reviews may be greatly reduced. However, prenegotiation audits are appropriate because the Brooks Act clearly requires agencies to negotiate contracts at a compensation determined to be "fair and reasonable to the Government." Also, a prenegotiation audit may be the best way to obtain detailed cost information to determine the validity of a firm's cost proposal, and to assure that the consultant has adequate knowledge of cost eligibles and documentation requirements. The expenses for prenegotiation audits and reviews would be eligible for Federal-aid funds under 23 U.S.C. 121 and 23 CFR 1.11.

The provisions of paragraph (d), State responsibility in local agency contracts, were reduced and included as part of § 172.1.

The requirements of paragraph (e), the Disadvantaged Business Enterprise program, are specified under 49 CFR Part 26. Section § 172.5(e), is redesignated as § 172.5(b).

The requirements of paragraph (f), Contractual responsibilities, are revised and moved to § 172.9(b). The section is revised to be consistent with 49 CFR 18.36(a) which requires States to use the same procurement procedures as if they were procuring with State funds, except where such procedures are inconsistent with Federal statutory requirements (see 49 CFR 18.4). Because States would be responsible for approving contracts and settlements, provided such contracts and settlements follow the same policies and procedures as the State would follow using State funds, there is a reduced requirement that such settlements be approved by the FHWA.

#### *Section 172.7 Methods of Procurement*

This section is redesignated as § 172.5 and revised. Generally, this section covers the methods that can be used for procurement of design engineering services. The same methods are still in the regulations, but have been simplified. The small purchase section is revised by raising the maximum amount for procurement by small purchase procedures from \$25,000 to \$100,000 and indexing the amount to conform to the simplified acquisition threshold set in 41 U.S.C. 403(11) and 49 CFR 18.36(d). In a memorandum to the FHWA Regional Administrators, dated June 26, 1996, the Director of the FHWA Office of Engineering raised the threshold from \$25,000 to \$100,000. This memo was issued to implement the change in the final rule, published on April 19, 1995 (60 FR 19646), concerning 49 CFR part 18 and the change to 41 U.S.C. 403(11), which defines the "simplified acquisition threshold" to mean \$100,000.

#### *Section 172.9 Compensation*

The information in paragraph (a) of this section is transferred to a new paragraph (a) in § 172.7, Audits, and revised to prohibit procedures enacted into State law after June 9, 1998. Paragraphs (b), (c), and (d) are removed.

#### *Section 172.11 Contract Modification*

This section is removed to promote uniformity with the common grant rule found in 49 CFR part 18.

#### *Section 172.13 Monitoring the Contract Work*

This section is removed to promote uniformity with the common grant rule found in 49 CFR part 18. The requirements of this section are covered by 49 CFR 18.36 which generally involve State procedures.

#### *Section 172.15 Alternate Procedures*

This section is removed because it implemented 23 U.S.C. 117, Certification Acceptance, which was repealed by section 1601 of the TEA-21 in 1998.

#### *Sections 172.21, 172.23, and 172.25 of Subpart B*

Subpart B, Private sector involvement program, is removed. This section was developed to meet the requirements of the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA), Public law 102-240, 105 Stat. 1914, section 1060, Private sector involvement program, but it has never been funded.

#### **Executive Order 12866 (Regulatory Planning and Review) and U.S. DOT Regulatory Policies and Procedures**

The FHWA has determined that this action is not a significant regulatory action within the meaning of Executive Order 12866 or significant within the meaning of the U.S. Department of Transportation's regulatory policies and procedures. This action will not adversely affect, in a material way, any sector of the economy. In addition, these changes would not interfere with any action taken or planned by another agency and will not materially alter the budgetary impact of any entitlements, grants, user fees, or loan programs. This rulemaking amends current regulations governing the administration of engineering and design related service contracts based on changes in the law. The FHWA does not anticipate that these changes will affect the total Federal funding available under the engineering and design related services contracts. Consequently, the economic impact of this rulemaking is minimal and a full regulatory evaluation is not required.

#### **Regulatory Flexibility Act**

In compliance with the Regulatory Flexibility Act (5 U.S.C. 601-612), the FHWA has evaluated the anticipated effects of this rule on small entities, such as local governments and businesses. Based on the evaluation, the FHWA hereby certifies that this action will not have a significant economic impact on a substantial number of small entities.

Essentially, this rulemaking implements certain changes in 23 U.S.C. 112, as mandated by recent laws. This rulemaking eliminates sections that were removed by the recent laws (NHS Act and TEA-21) and other sections that were not required by law or that were outdated. Thus, the impact upon the small entities affected is negligible because the FHWA is merely updating, simplifying, and clarifying existing procedures.

#### **Unfunded Mandates Reform Act of 1995**

This final rule will not impose a Federal mandate resulting in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more in any one year (2 U.S.C. 1531 *et seq.*).

#### **Executive Order 13132 (Federalism)**

The action has been analyzed in accordance with the principles and criteria contained in Executive Order 13132, dated August 4, 1999, and the FHWA has determined that this action

does not have a substantial direct affect or sufficient federalism implications on States that would limit the policymaking discretion of the States. Nothing in this document directly preempts any State law or regulation.

#### **Executive Order 12372 (Intergovernmental Review)**

Catalog of Federal Domestic Assistance Program Number 20.205, Highway Planning and Construction. The regulations implementing Executive Order 12372 regarding intergovernmental consultation on Federal programs and activities apply to this program.

#### **Paperwork Reduction Act**

This action does not contain a collection of information requirement for the purpose of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501–3520.

#### **National Environmental Policy Act**

The agency has analyzed this action for the purpose of the National Environmental Policy Act of 1969 (42 U.S.C. 4321–4347) and has determined that this action will not have any effect on the quality of the environment.

#### **Executive Order 12630 (Taking of Private Property)**

This rule will not affect a taking of private property or otherwise have taking implications under Executive Order 12630, Governmental Actions and Interference with Constitutionally Protected Property Rights.

#### **Executive Order 12988 (Civil Justice Reform)**

This action meets applicable standards in section 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden.

#### **Executive Order 13045 (Protection of Children)**

We have analyzed this action under Executive Order 13045, Protection of Children from Environmental Health Risks and Safety Risks. This rule is not an economically significant rule and does not concern an environmental risk to health or safety that may disproportionately affect children.

#### **Executive Order 13175 (Tribal Consultation)**

The FHWA has analyzed this action under Executive Order 13175, dated November 6, 2000, and believes it will not have substantial direct effects on one or more tribes; will not impose substantial direct compliance costs on Indian tribal governments; and will not

preempt tribal law. This rule primarily involves U.S. Department of Transportation grant funds to State, county and city Department of Transportation agencies for the construction and maintenance of highways. Therefore, this final rule will not have a substantial direct impact on one or more Indian tribes and a tribal summary impact statement is not required.

#### **Executive Order 13211 (Energy Effects)**

We have analyzed this rule under Executive Order 13211, Actions Concerning Regulations That Significantly Affect Energy Supply, Distribution, or Use. We have determined that it is a not significant energy action under that order because it is not a significant regulatory action under Executive Order 12866 and is not likely to have a significant adverse effect on the supply, distribution, or use of energy. Therefore, a Statement of Energy Effects under Executive Order 13211 is not required.

#### **Regulation Identification Number**

A regulation identification number (RIN) is assigned to each regulatory action listed in the Unified Agenda of Federal Regulations. The Regulatory Information Service Center publishes the Unified Agenda in April and October of each year. The RIN number contained in the heading of this document can be used to cross reference this action with the Unified Agenda.

#### **List of Subjects in 23 CFR Part 172**

Government procurement, Grant programs-transportation, Highways and roads.

Issued on: June 5, 2002

#### **Mary E. Peters**

*Administrator, Federal Highway Administration.*

In consideration of the foregoing, the FHWA revises part 172 of title 23, Code of Federal Regulations, to read as set forth below:

### **PART 172—ADMINISTRATION OF ENGINEERING AND DESIGN RELATED SERVICE CONTRACTS**

Sec.

- 172.1 Purpose and applicability.
- 172.3 Definitions.
- 172.5 Methods of procurement.
- 172.7 Audits.
- 172.9 Approvals.

**Authority:** 23 U.S.C. 112, 114(a), 302, 315, and 402; 40 U.S.C. 541 *et seq.*; sec.1205(a), Pub. L. 105–178, 112 Stat. 107 (1998); sec. 307, Pub. L. 104–59, 109 Stat. 568 (1995); sec. 1060, Pub. L. 102–240, 105 Stat. 1914, 2003 (1991); 48 CFR 12 and 31; 49 CFR 1.48(b) and 18.

#### **§ 172.1 Purpose and applicability.**

This part prescribes policies and procedures for the administration of engineering and design related service contracts under 23 U.S.C. 112 as supplemented by the common grant rule, 49 CFR part 18. It is not the intent of this part to release the grantee from the requirements of the common grant rule. The policies and procedures involve federally funded contracts for engineering and design related services for projects subject to the provisions of 23 U.S.C. 112(a) and are issued to ensure that a qualified consultant is obtained through an equitable selection process, that prescribed work is properly accomplished in a timely manner, and at fair and reasonable cost. Recipients of Federal funds shall ensure that their subrecipients comply with this part.

#### **§ 172.3 Definitions.**

As used in this part:

*Audit* means a review to test the contractor's compliance with the requirements of the cost principles contained in 48 CFR part 31.

*Cognizant agency* means any Federal or State agency that has conducted and issued an audit report of the consultant's indirect cost rate that has been developed in accordance with the requirements of the cost principles contained in 48 CFR part 31.

*Competitive negotiation* means any form of negotiation that utilizes the following:

(1) Qualifications-based procedures complying with title IX of the Federal Property and Administrative Services Act of 1949 (Public Law 92–582, 86 Stat. 1278 (1972));

(2) Equivalent State qualifications-based procedures; or

(3) A formal procedure permitted by State statute that was enacted into State law prior to the enactment of Public Law 105–178 (TEA–21) on June 9, 1998.

*Consultant* means the individual or firm providing engineering and design related services as a party to the contract.

*Contracting agencies* means State Departments of Transportation (State DOTs) or local governmental agencies that are responsible for the procurement of engineering and design related services.

*Engineering and design related services* means program management, construction management, feasibility studies, preliminary engineering, design, engineering, surveying, mapping, or architectural related services with respect to a construction project subject to 23 U.S.C. 112(a).

*One-year applicable accounting period* means the annual accounting period for which financial statements are regularly prepared for the consultant.

#### § 172.5 Methods of procurement.

(a) *Procurement.* The procurement of Federal-aid highway contracts for engineering and design related services shall be evaluated and ranked by the contracting agency using one of the following procedures:

(1) *Competitive negotiation.* Contracting agencies shall use competitive negotiation for the procurement of engineering and design related services when Federal-aid highway funds are involved in the contract. These contracts shall use qualifications-based selection procedures in the same manner as a contract for architectural and engineering services is negotiated under title IX of the Federal Property and Administrative Services Act of 1949 (40 U.S.C. 541–544) or equivalent State qualifications-based requirements. The proposal solicitation (project, task, or service) process shall be by public announcement, advertisement, or any other method that assures qualified in-State and out-of-State consultants are given a fair opportunity to be considered for award of the contract. Price shall not be used as a factor in the analysis and selection phase. Alternatively, a formal procedure adopted by State Statute enacted into law prior to June 9, 1998 is also permitted under paragraph (a)(4) of this section.

(2) *Small purchases.* Small purchase procedures are those relatively simple and informal procurement methods where an adequate number of qualified sources are reviewed and the total contract costs do not exceed the simplified acquisition threshold fixed in 41 U.S.C. 403(11). Contract requirements should not be broken down into smaller components merely to permit the use of small purchase requirements. States and subrecipients of States may use the State's small purchase procedures for the procurement of engineering and design related services provided the total contract costs do not exceed the simplified acquisition threshold fixed in 41 U.S.C. 403(11).

(3) *Noncompetitive negotiation.* Noncompetitive negotiation may be used to procure engineering and design related services on Federal-aid participating contracts when it is not feasible to award the contract using competitive negotiation, equivalent State qualifications-based procedures, or

small purchase procedures. Contracting agencies shall submit justification and receive approval from the FHWA before using this form of contracting.

Circumstances under which a contract may be awarded by noncompetitive negotiation are limited to the following:

(i) The service is available only from a single source;

(ii) There is an emergency which will not permit the time necessary to conduct competitive negotiations; or

(iii) After solicitation of a number of sources, competition is determined to be inadequate.

(4) *State statutory procedures.* Contracting agencies may procure engineering and design related services using an alternate selection procedure established in State statute enacted into law before June 9, 1998.

(b) *Disadvantaged Business Enterprise (DBE) program.* The contracting agency shall give consideration to DBE consultants in the procurement of engineering and design related service contracts subject to 23 U.S.C. 112(b)(2) in accordance with 49 CFR part 26.

(c) *Compensation.* The cost plus a percentage of cost and percentage of construction cost methods of compensation shall not be used.

#### § 172.7 Audits.

(a) *Performance of audits.* When State procedures call for audits of contracts or subcontracts for engineering design services, the audit shall be performed to test compliance with the requirements of the cost principles contained in 48 CFR part 31. Other procedures may be used if permitted by State statutes that were enacted into law prior to June 9, 1998.

(b) *Audits for indirect cost rate.* Contracting agencies shall use the indirect cost rate established by a cognizant agency audit for the cost principles contained in 48 CFR part 31 for the consultant, if such rates are not under dispute. A lower indirect cost rate may be used if submitted by the consultant firm, however the consultant's offer of a lower indirect cost rate shall not be a condition of contract award. The contracting agencies shall apply these indirect cost rates for the purposes of contract estimation, negotiation, administration, reporting, and contract payment and the indirect cost rates shall not be limited by any administrative or de facto ceilings. The consultant's indirect cost rates for its one-year applicable accounting period shall be applied to the contract, however once an indirect cost rate is established for a contract it may be extended beyond the one year applicable accounting period provided

all concerned parties agree. Agreement to the extension of the one-year applicable period shall not be a condition of contract award. Other procedures may be used if permitted by State statutes that were enacted into law prior to June 9, 1998.

(c) *Disputed audits.* If the indirect cost rate(s) as established by the cognizant audit in paragraph (b) of this section are in dispute, the parties of any proposed new contract must negotiate a provisional indirect cost rate or perform an independent audit to establish a rate for the specific contract. Only the consultant and the parties involved in performing the indirect cost audit may dispute the established indirect cost rate. If an error is discovered in the established indirect cost rate, the rate may be disputed by any prospective user.

(d) *Prenotification; confidentiality of data.* The FHWA and recipients and subrecipients of Federal-aid highway funds may share the audit information in complying with the State or subrecipient's acceptance of a consultant's overhead rates pursuant to 23 U.S.C. 112 and this part provided that the consultant is given notice of each use and transfer. Audit information shall not be provided to other consultants or any other government agency not sharing the cost data, or to any firm or government agency for purposes other than complying with the State or subrecipient's acceptance of a consultant's overhead rates pursuant to 23 U.S.C. 112 and this part without the written permission of the affected consultants. If prohibited by law, such cost and rate data shall not be disclosed under any circumstance, however should a release be required by law or court order, such release shall make note of the confidential nature of the data.

#### § 172.9 Approvals.

(a) *Written procedures.* The contracting agency shall prepare written procedures for each method of procurement it proposes to utilize. These written procedures and all revisions shall be approved by the FHWA for recipients of federal funds. Recipients shall approve the written procedures and all revisions for their subrecipients. These procedures shall, as appropriate to the particular method of procurement, cover the following steps:

(1) In preparing a scope of work, evaluation factors and cost estimate for selecting a consultant;

(2) In soliciting proposals from prospective consultants;

(3) In the evaluation of proposals and the ranking/selection of a consultant;

(4) In negotiation of the reimbursement to be paid to the selected consultant;

(5) In monitoring the consultant's work and in preparing a consultant's performance evaluation when completed; and

(6) In determining the extent to which the consultant, who is responsible for the professional quality, technical accuracy, and coordination of services, may be reasonably liable for costs resulting from errors or deficiencies in design furnished under its contract.

(b) *Contracts.* Contracts and contract settlements involving design services for projects that have not been delegated to the State under 23 U.S.C. 106(c), that do not fall under the small purchase procedures in § 172.5(a)(2), shall be subject to the prior approval by FHWA, unless an alternate approval procedure has been approved by FHWA.

(c) *Major projects.* Any contract, revision of a contract or settlement of a contract for design services for a project that is expected to fall under 23 U.S.C. 106(h) shall be submitted to the FHWA for approval.

(d) *Consultant services in management roles.* When Federal-aid highway funds participate in the contract, the contracting agency shall receive approval from the FHWA before hiring a consultant to act in a management role for the contracting agency.

[FR Doc. 02-14751 Filed 6-11-02; 8:45 am]

BILLING CODE 4910-22-P

## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 8999]

RIN 1545-AY13

#### Treaty Guidance Regarding Payments With Respect to Domestic Reverse Hybrid Entities

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

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations under section 894 relating to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (domestic

reverse hybrid entities). The regulations affect the determination of tax treaty benefits with respect to U.S. source income of foreign persons.

**DATES:** *Effective Date:* These regulations are effective June 12, 2002.

*Applicability Date:* These regulations are applicable to items of income paid by a domestic reverse hybrid entity on or after June 12, 2002 with respect to amounts received by the domestic reverse hybrid entity on or after June 12, 2002.

**FOR FURTHER INFORMATION CONTACT:** Elizabeth U. Karzon at (202) 622-3880 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

On February 27, 2001, the IRS and Treasury published a notice of proposed rulemaking (REG-107101-00) in the **Federal Register** (66 FR 12445) under section 894 relating to whether payments made by domestic reverse hybrid entities to their interest holders are eligible for benefits under income tax treaties. A limited number of comments responding to the notice of proposed rulemaking were received. After consideration of these comments, the proposed regulations are adopted as final regulations as revised by this Treasury decision.

##### Explanation of Provisions

###### I. General

These final section 894 regulations clarify the availability of treaty benefits on payments made by a domestic reverse hybrid entity (DRH) to its interest holders. A DRH is a U.S. entity that the United States treats as non-fiscally transparent (e.g., as a corporation), but the interest holder's country treats as fiscally transparent (e.g., as a partnership or branch). These regulations are the final piece of guidance associated with section 894 regulations finalized on July 3, 2000 (TD 8889; 65 FR 40993) (the "2000 regulations"), that generally address the availability of treaty benefits on items of U.S. source income paid to hybrid entities (i.e., entities treated as fiscally transparent by one jurisdiction but non-fiscally transparent by another).

The preamble to the 2000 regulations noted that the IRS and Treasury had learned that non-U.S. multinationals were establishing DRH structures in the United States to manipulate the U.S. tax treaty network to obtain tax-advantaged financing. The IRS and Treasury notified the public in that preamble that they intended to issue regulations to address this situation.

Proposed regulations were issued on February 27, 2001. The proposed regulations provided guidance with respect to two distinct issues involving domestic reverse hybrid entities. First, to resolve a technical question raised by commentators regarding the application of the 2000 regulations, the proposed regulations clarified that a payment by a domestic reverse hybrid entity to a foreign interest holder may be eligible for treaty benefits. No comments were received on this portion of the proposed regulations, and the rule in the proposed regulations is accordingly adopted without change in these final regulations.

The proposed regulations also addressed certain structures involving domestic reverse hybrid entities that Treasury and the IRS believed represented the use of such entities to obtain inappropriate treaty benefits. The comments received in response to this portion of the proposed regulations generally confirmed the need for regulations to address the use of DRH structures by non-U.S. companies. One commentator wrote in its comment that "regulations addressing the DRH structure are appropriate." The commentator noted that DRH structures are "relatively uncommon" with the exception of their use by highly sophisticated non-U.S. multinational groups to procure acquisition financing at a tax-advantaged rate vis-a-vis their U.S. competitors.

Several commentators expressed concern that the approach taken in the proposed DRH regulations might erode the simplicity achieved by the section 7701 entity classification rules, known as the Check-the-Box (CTB) regulations. The IRS and Treasury have carefully considered this comment, but continue to believe that the approach in these final regulations is appropriate. The regulations only apply to a DRH structure established by a group of taxpayers related to each other by 80% common ownership. This high ownership requirement minimizes the possibility that a taxpayer might inadvertently establish such a structure. In addition, the comments confirm that DRH structures remain "relatively uncommon." Thus, any loss of the simplification benefits of the CTB regulations also will be relatively uncommon.

One commentator suggested that, rather than adopt the approach in the regulations, the IRS and Treasury should pursue an approach under section 1503(d) to directly address structures similar to, and potentially including, the DRH that rely on hybrid entity structures to deduct the same