Internal Revenue

bulletin

Bulletin No. 2003–8
February 24, 2003

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2003–21, page 509.
LIFO; price indexes; department stores. The December 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 2002.

Rev. Rul. 2003–22, page 494.
Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through March 2003. This ruling announces errors in the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March 2003. It also provides a list of the corrected bond factor amounts. Rev. Rul. 2003–2 revoked.

Rev. Rul. 2003–23, page 511.
Estimated tax penalty safe harbor. This ruling addresses the application of section 6654(d)(1)(B)(ii) of the Code where an individual filed a late original return for the preceding year.

T.D. 9030, page 495.
Final regulations under section 121 of the Code provide rules relating to the exclusion of gain from the sale or exchange of a principal residence and for the application of the exclusion to an individual's bankruptcy estate.

T.D. 9031, page 504.
REG–138882–02, page 522.
Temporary and proposed regulations under section 121 of the Code provide rules relating to the reduced maximum exclusion of gain from the sale or exchange of property that the taxpayer has not owned and used as the taxpayer's principal residence for two of the preceding five years or when the taxpayer has excluded gain from the sale or exchange of a principal residence within the preceding two years.

T.D. 9041, page 510.
Final and temporary regulations under section 3406 of the Code allow a payor's authorized agent to participate in the Taxpayer Identification Number (TIN) Matching Program.

REG–116641–01, page 518.
Proposed regulations under sections 3406 and 6724 of the Code provide guidance relating to the Taxpayer Identification Number (TIN) Matching Program and to information reporting requirements, information reporting penalties, and backup withholding requirements for payment card transactions. The regulations provide that backup withholding does not apply to payment card transactions if the reportable payments are made through a Qualified Payment Card Agent (QPCA) and the payee is a qualified payee. The regulations also provide special Taxpayer Identification Number (TIN) solicitation rules under section 6724 for payments made through a QPCA. A public hearing is scheduled for May 21, 2003.

Notice 2003–13, page 513.
This notice provides a proposed revenue procedure that would establish a procedure for a payment card organization to request a determination that it is a Qualified Payment Card Agent. A QPCA could act on behalf of cardholder/payors in soliciting, collecting, and validating merchants' names, Taxpayer Identification Numbers (TINs), and corporate status, and on behalf of merchant/payees in furnishing such information to cardholder/payors.

Findings Lists begin on page ii.

(Continued on the next page)

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2003–9, page 516.
This procedure expands the Taxpayer Identification Number (TIN) Matching Program, permitting payors to verify, prior to filing, payee TINs required to be reported on information returns and payee statements. The federal TIN Matching Program established by Rev. Proc. 97–31 was limited to federal agencies. Rev. Proc. 2003–9 establishes an on-line system open to all payors of reportable payments and their authorized agents. Program participants will be able to rely on a verified TIN/name match as reasonable cause under section 6724(a) of the Code, which will provide significant incentive for payors to check and correct payee TINs before filing. Rev. Proc. 97–31 modified.

EMPLOYEE PLANS

Notice 2003–14, page 515.
Weighted average interest rate update. The weighted average interest rate for February 2003 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through March 2003. This ruling announces errors in the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March 2003. It also provides a list of the corrected bond factor amounts. Rev. Rul. 2003–2 revoked.

Rev. Rul. 2003–22

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of bond factor amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through March 2003.

Due to a miscalculation, Rev. Rul. 2003–2, 2003–2 I.R.B. 251, is in error regarding dispositions of qualified low-income buildings or interests therein during the period January through March 2003. The present revenue ruling provides the corrected bond factor amounts.

Under the authority of § 7805(b), taxpayers that posted bonds and taxpayers that established Treasury Direct Accounts under Rev. Proc. 99–11, based upon the above mentioned bond factor amounts may continue to rely on those figures. Taxpayers that choose to amend their previously posted bonds by using the corrected bond factor amounts listed in this revenue ruling may do so by submitting an amended Form 8693, *Low-Income Housing Tax Credit Disposition Bond,* to the Internal Revenue Service Center, Philadelphia, PA 19255. The amended form may be submitted either by the taxpayer or the surety. Taxpayers that choose to amend the amount of securities pledged in their previously established Treasury Direct Account by using the corrected bond factor amounts listed in this revenue ruling should contact the Bureau of Public Debt, Division of Customer Service, IRS Collateral Desk at (304) 480–6158 for further information.

Table 1
Rev. Rul. 2003–22
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Jan '03	16.23	30.04	41.83	51.93	60.50	60.24	60.12	60.11	60.18	60.39	60.62
Feb '03	16.23	30.04	41.83	51.93	60.50	60.09	59.97	59.96	60.03	60.24	60.47
Mar '03	16.23	30.04	41.83	51.93	60.50	59.94	59.82	59.82	59.89	60.10	60.33

Table 1 (cont'd)
Rev. Rul. 2003–22
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year			
Month of Disposition	2000	2001	2002	2003
Jan '03	60.89	61.55	62.49	62.68
Feb '03	60.75	61.41	62.33	62.68
Mar '03	60.62	61.27	62.19	62.68

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; Rev. Rul. 2001–53, 2001–2 C.B. 488; and Rev. Rul. 2002–72, 2002–44 I.R.B. 759.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 2003–2, 2003–2 I.R.B. 251, is revoked.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran at (202) 622–3040 (not a toll-free call).

Section 121.—Exclusion of Gain From Sale of Principal Residence

26 CFR 1.121–1: Exclusion of gain from sale or exchange of a principal residence.

T.D. 9030

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Exclusion of Gain From Sale or Exchange of a Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence. These regulations reflect changes to the law made by the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998.

DATES: *Effective Date:* These regulations are effective December 24, 2002.

Applicability Date: For dates of applicability, see §§ 1.121–1(f), 1.121–2(c), 1.121–3(l), 1.121–4(l), and 1.1398–3(d).

FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On October 10, 2000, the IRS and the Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–105235–99, 2000–44 I.R.B. 447 [65 FR 60136]) under section 121 of the Internal Revenue Code. Comments were specifically requested regarding what circumstances should qualify as unforeseen for purposes of the reduced maximum exclusion under section 121(c). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on January 26, 2001.

After considering all of the comments, the proposed regulations are adopted as amended by this Treasury decision. Proposed and temporary regulations regarding the reduced maximum exclusion are also published in this issue of the Federal Register.

On September 9, 2002, the IRS published Notice 2002–60, 2002–36 I.R.B. 482, which provides that certain taxpayers affected by the September 11, 2001, terrorist attacks may claim a reduced maximum exclusion for a sale or exchange of the taxpayer's principal residence by reason of unforeseen circumstances.

Explanation and Summary of Comments

1. *Exclusion of Gain from the Sale or Exchange of a Principal Residence*

Under section 121 and the proposed regulations, a taxpayer may exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange.

a. *Principal residence*

The proposed regulations provide that whether property is used by the taxpayer as the taxpayer's residence, and whether the property is used as the taxpayer's principal residence, depends upon all the facts and circumstances. The proposed regulations further provide that if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence.

Commentators requested a bright line test or a list of factors to identify a property as the taxpayer's principal residence in the case of a taxpayer with multiple residences. Other commentators questioned whether the property that a taxpayer uses a majority of the time during the year should generally be considered the taxpayer's principal residence, arguing that the determination of the taxpayer's principal residence should be judged on a day-by-day, rather than a year-by-year, basis.

The final regulations continue to provide that the residence that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence. However, this test is not dispositive. The final regulations also include a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence.

b. *Vacant land*

Commentators requested clarification of the circumstances in which vacant land surrounding a residential structure would be treated as part of the residence for purposes of section 121. Several commentators maintained that a taxpayer who sells vacant land should be entitled to the section 121 exclusion if the taxpayer used the vacant land in conjunction with a dwelling unit as the taxpayer's principal residence for at least two years.

Under section 1034 and former section 121, a sale of vacant land that did not include a dwelling unit did not qualify as a sale of the taxpayer's residence. See Rev. Rul. 56–420, 1956–2 C.B. 519; Rev. Rul 83–50, 1983–1 C.B. 41; *O'Barr v. Commissioner*, 44 T.C. 501 (1965); *Roy v. Commissioner*, T.C. Memo. 1995–23; *Hale v. Commissioner,* T.C. Memo. 1982–527. However, if the sale of vacant land was one of a series of transactions that included the sale of the house, and the series of transactions all occurred during the replacement period provided by section 1034 (two years before or after the date of the taxpayer's purchase of a replacement residence), the sale of vacant land and the sale of the house were treated as one sale. See *Bogley v. Commissioner,* 263 F.2d 746 (4th Cir. 1959); Rev. Rul. 76–541, 1976–2 C.B. 246.

Consequently, the final regulations provide that section 121 applies to the sale or exchange of vacant land that the taxpayer has owned and used as part of the taxpayer's principal residence if the sale or exchange of the dwelling unit occurs within two years before or after the sale or exchange of the vacant land. The vacant land must be adjacent to land containing the dwelling unit and the sale or exchange of the vacant land must otherwise satisfy the requirements of section 121.

For purposes of section 121(b)(1) and (2) (regarding the maximum limitation amount of the section 121 exclusion), sales or exchanges of the dwelling unit and vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the vacant land and dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121–2(a)(3)(i) (relating to the limitation for certain joint returns) apply. Sales or exchanges of the dwelling unit and adjacent vacant land in separate transactions are disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to each other but are taken into account as a sale or exchange of a principal residence on the date of each transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

2. *Use as a Principal Residence*

a. *Occupancy requirement*

Numerous commentators asserted that the two-year use requirement of section 121 should not require actual occupancy. Instead, they argued for a facts and circumstances test similar to the test employed under section 1034. Under that test, a taxpayer's non-occupancy of a residence would count as use if the taxpayer did not intend to abandon the property as the taxpayer's principal residence. The final regulations do not adopt this suggestion because it is inconsistent with the statutory approach under section 121 of aggregating periods of use over a five-year period, and with the legislative history that provides that "a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange." See H.R. Rep. No. 148, 105th Cong., 1st Sess. 348 (1997), 1997–4 (Vol. 1) C.B. 319, 670; S. Rep. No. 33, 105th Cong., 1st Sess. 37 (1997), 1997–4 (Vol. 2) C.B. 1067, 1117; H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 386 (1997), 1997–4 (Vol. 2) C.B. 1457, 1856.

Commentators proposed a special exception to the occupancy requirement for taxpayers who are absent from the home for an extended period of time due to employment but have not purchased a replacement residence. Other commentators suggested that members of the uniformed services and the United States Foreign Service should be accorded a special exception because they are often away from home for extended periods of time. A commentator also requested that the home daycare industry be exempted from the occupancy requirement because calculating the days of actual occupancy presents a particular difficulty for home daycare providers who often use the same space for residential and business purposes.

The final regulations do not adopt these comments because there is no specific authority under section 121 to provide exceptions to the use requirement except in the cases of property of a deceased spouse (section 121(d)(2)), property of a former spouse (section 121(d)(3)(B)), and out-of-residence care (section 121(d)(7)). Moreover, section 1034 contained a special rule for members of the Armed Forces, which Congress did not include in enacting section 121.

b. *Short temporary absences*

Commentators requested that the regulations specify a maximum period of time that would constitute a short temporary absence from the residence and be considered use for purposes of satisfying the two-year use requirement. One commentator suggested that periods of up to five years away from home due to international employment assignments should be considered short temporary absences.

Because the determination of whether an absence is short and temporary depends on the facts and circumstances, the final regulations do not adopt these suggestions.

c. *Property used in part as a principal residence*

The proposed regulations provide that if a taxpayer satisfies the use requirement with respect to only a portion of the property sold or exchanged, section 121 will apply only to the gain allocable to that portion. Thus, if the residence was used partially for residential purposes and partially for business purposes (mixed-use property), only that part of the gain allocable to the residential portion is excludable under section 121.

Under section 121(d)(6), the exclusion does not apply to so much of the gain from the sale of the property as does not exceed depreciation attributable to periods after May 6, 1997. Commentators suggested that the enactment of section 121(d)(6) illustrates legislative intent to eliminate the allocation requirement for mixed-use property that existed under prior law.

The IRS and Treasury Department have reconsidered the allocation rules of the proposed regulations. The final regulations provide that section 121 will not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the non-residential portion is separate from the dwelling unit. Additionally, if the depreciation for periods after May 6, 1997, attributable to the non-residential portion of the property exceeds the gain allocable to the non-residential portion of the property, the excess will not reduce the section 121 exclusion applicable to gain allocable to the residential portion of the property. No allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit, however, section 121 will not apply to the gain to the extent of any post-May 6, 1997, depreciation adjustments. The final regulations provide that the term *dwell-*

ing unit has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

A commentator asked for clarification regarding how to allocate the basis and the amount realized under the allocation rules between the portions of the property used for business and residential purposes. The commentator suggested that the regulations should require allocation on the same basis used to determine previous depreciation deductions. The regulations adopt this comment and provide that the taxpayer must use the same method to allocate the basis and the amount realized between the business and residential portions of the property as the taxpayer used to allocate the basis for purposes of depreciation, if applicable.

3. *Ownership by Trusts*

Commentators suggested that the regulations adopt the holdings of Rev. Rul. 66–159, 1966–1 C.B. 162, and Rev. Rul. 85–45, 1985–1 C.B. 183, regarding treatment of sales of property by certain trusts. Rev. Rul. 66–159 holds that, in cases in which the grantor is treated as the owner of the entire trust under sections 676 and 671, gain realized from the sale of trust property used by the grantor as the grantor's principal residence qualifies under section 1034 for the rollover of gain into a replacement residence. Because the grantor is treated as the owner of the entire trust, the sale by the trust will be treated for federal income tax purposes as if made by the grantor.

Rev. Rul. 85–45 holds that, in cases in which the beneficiary of a trust is treated as the owner of the entire trust under sections 678 and 671, gain realized from the sale of trust property used by the beneficiary as the beneficiary's principal residence qualifies for the one-time exclusion of gain from the sale of a residence under former section 121. For the period that the beneficiary is treated as the owner of the entire trust, the beneficiary will be treated as owning the property for section 121 purposes, and the sale by the trust will be treated for federal income tax purposes as if made by the beneficiary.

The final regulations adopt these suggestions and provide that, if a residence is held by a trust, a taxpayer is treated as the owner and the seller of the residence during the period that the taxpayer is treated as the owner of the trust or the portion of the trust that includes the residence under sections 671 through 679. The regulations provide similar treatment for certain single-owner entities.

4. *Dollar Limitations Applicable to Jointly Owned Property*

Commentators requested further clarification of the application of the dollar limitations of section 121(b) to non-married taxpayers who are joint owners of a residence. In response, the final regulations provide that each unmarried taxpayer who jointly owns a principal residence may be eligible to exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property.

5. *Reduced Maximum Exclusion*

Section 121(c) provides an exclusion of gain in a reduced maximum amount for taxpayers who have owned or used a principal residence for less than two of the five years preceding the sale or exchange or who have excluded gain from another sale or exchange during the last two years. Taxpayers who fail to meet any of these conditions may qualify for the reduced maximum exclusion if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances.

The proposed regulations explain the general rule and the computation of the reduced maximum exclusion but do not provide rules clarifying what is a sale or exchange by reason of a change in place of employment, health, or unforeseen circumstances. Comments were requested regarding what circumstances should qualify as unforeseen. Because the rules formulated in response to the comments are extensive, the IRS and Treasury Department have concluded that it is appropriate to publish proposed and temporary regulations to provide the public with adequate notice and opportunity to comment. These proposed and temporary regulations are published elsewhere in this issue of the Bulletin. The final regulations provide guidance regarding the computation of the reduced maximum exclusion.

6. *Property of Deceased Spouse*

Commentators suggested that the regulations allow a surviving spouse to exclude up to $500,000 of gain if the sale or exchange of the marital home occurs within one year of the death of the decedent spouse and the requirements of section 121 are otherwise met. Under section 121(b)(2), the $500,000 exclusion is only available to spouses who file a joint return. A surviving spouse is eligible to file a joint return with the decedent spouse only for the year of the decedent spouse's death. Therefore, the final regulations do not adopt this suggestion.

Commentators also requested clarification regarding the computation of basis and gain for surviving spouses. They asked for guidance regarding the advantages of titling the marital home in the names of both spouses so that a surviving spouse can obtain a step-up in basis and, consequently, realize less gain from the disposition of the marital home. Because the rules regarding the computation of basis and gain are outside the scope of these regulations, the final regulations do not address these issues.

7. *Partial Interests*

Commentators suggested that the regulations clarify that a taxpayer who sells a partial interest in the taxpayer's principal residence and more than two years later sells the remaining interest in the same property is entitled to use up to the full exclusion for each sale.

The final regulations provide that a taxpayer may exclude gain from the sale or exchange of partial interests (other than interests remaining after the sale or exchange of a remainder interest) in the taxpayer's principal residence if the interest sold or exchanged includes an interest in the dwelling unit.

However, the IRS and Treasury Department believe that allowing more than the maximum limitation amount with respect to the same principal residence is contrary to the language and intent of section 121. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of partial interests.

In this regard, for purposes of determining the maximum limitation amount under section 121(b)(1) and (2), the sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121–2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

8. *Elections Under Sections 121(d)(8) and (f)*

Commentators asked for clarification regarding when a taxpayer may make or revoke an election under section 121(d)(8) (election to have the section 121 exclusion apply to a sale or exchange of a remainder interest in the taxpayer's principal residence) or section 121(f) (election to have the section 121 exclusion not apply to a sale or exchange of the taxpayer's principal residence). The final regulations adopt and clarify the provisions of the proposed regulations and provide that a taxpayer may make or revoke either election at any time before the expiration of a three-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

9. *Reporting Sales or Exchanges*

Commentators recommended the creation of a form for taxpayers to use to report the sale or exchange of a principal residence even if the gain is entirely excludable under section 121. The final regulations do not adopt this suggestion because, unlike sales or exchanges under section 1034, no tax attributes of the sold residence carry over to a new residence. Therefore the reporting of excluded gain is unnecessary and would be unduly burdensome for taxpayers.

10. *Election to Apply Regulations Retroactively*

The regulations provide that taxpayers who would otherwise qualify under the provisions of §§ 1.121–1 through 1.121–4 of the final regulations to exclude gain from a sale or exchange before the effective date of the regulations but on or after May 7, 1997, may elect to apply the provisions of the final regulations for any years for which the period of limitation under section 6511 has not expired. A taxpayer may make the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of the final regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

11. *Audit Protection*

The regulations provide that the IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of these regulations but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the proposed regulations that preceded these final regulations generally will be considered a reasonable, good faith effort.

12. *Section 121 Exclusion in Individuals' Title 11 Cases*

The regulations provide that the bankruptcy estate of an individual in a chapter 7 or 11 bankruptcy case under title 11 of the United States Code succeeds to and takes into account the individual's section 121 exclusion if the individual satisfies the requirements of section 121. Although the effective date for this provision is on or after publication of final regulations in the **Federal Register**, in view of the IRS's acquiescence in the case of *Internal Revenue Service v. Waldschmidt (In re Bradley)*, 222 B.R. 313 (M.D. Tenn. 1998), AOD CC–1999–009 (August 30, 1999), and Chief Counsel Notice (35)000–162 (August 10, 1999), the IRS will not challenge a position taken prior to the effective date of these regulations that a bankruptcy estate may use the section 121 exclusion if the debtor would otherwise satisfy the section 121 requirements.

13. *Effective Date*

These regulations apply to sales or exchanges on or after December 24, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1398–3 also issued under 26 U.S.C. 1398(g) * * *

Par. 2. Sections 1.121–1, 1.121–2, 1.121–3, and 1.121–4 are revised to read as follows:

§ 1.121–1 Exclusion of gain from sale or exchange of a principal residence.

(a) *In general.* Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

(b) *Residence*—(1) *In general.* Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

(2) *Principal residence.* In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to—

(i) The taxpayer's place of employment;

(ii) The principal place of abode of the taxpayer's family members;

(iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;

(iv) The taxpayer's mailing address for bills and correspondence;

(v) The location of the taxpayer's banks; and

(vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

(3) *Vacant land*—(i) *In general.* The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless—

(A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;

(B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;

(C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and

(D) The requirements of section 121 have otherwise been met with respect to the vacant land.

(ii) *Limitations*—(A) *Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121–2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) *Sale or exchange of more than one principal residence in 2-year period.* If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

(C) *Sale or exchange of vacant land before dwelling unit.* If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

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

Example 1. Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

Example 2. Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

Example 3. In 1991, Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005, C sells 8 acres of the land and realizes a gain of $110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the $110,000 of gain. In March 2007, C sells the house and remaining 2 acres realizing a gain of $180,000 from the sale of the house. C may exclude the $180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for $70,000 ($250,000 - $180,000 gain previously excluded) of the $110,000 gain from the sale of the 8 acres.

Example 4. In 1998, Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999, D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003, D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at a loss of $25,000. D realizes $270,000 of gain from the sale of the 29 acres. D may exclude the $245,000 gain from the 2 sales.

(c) *Ownership and use requirements*—(1) *In general.* The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x 2). The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

(2) *Use.* (i) In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

(ii) *Determination of use during periods of out-of-residence care.* If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

(3) *Ownership*—(i) *Trusts.* If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

(ii) *Certain single owner entities.* If a residence is owned by an eligible entity (within the meaning of § 301.7701–3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701–3 of this chapter, the owner will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

(4) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that § 1.121–3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants from that date until April 18, 2000, when he sells it. A is eligible for the section 121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale.

Example 2. Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

Example 3. Taxpayer C lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997, until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995, until February 1, 1998).

Example 4. Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c)(2) of this section, the period of the sabbatical leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

Example 5. Taxpayer E purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of the residence because, under paragraph (c)(2) of this section, the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

(d) *Depreciation taken after May 6, 1997*—(1) *In general.* The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

(2) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

Example. On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A took depreciation deductions totaling $14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, A sells the property on August 1, 2001. A's gain realized from the sale is $40,000. A has no other section 1231 or capital gains or losses for 2001. Only $26,000 ($40,000 gain realized - $14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize $14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

(e) *Property used in part as a principal residence*—(1) *Allocation required.* Section 121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, section 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by paragraph (d) of this section.

(2) *Dwelling unit.* For purposes of this paragraph (e), the term *dwelling unit* has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

(3) *Method of allocation.* For purposes of determining the amount of gain allocable to the residential and non-residential

portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in section 1250(b)(3)), if applicable.

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

Example 1. Non-residential use of property not within the dwelling unit. (i) Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of $9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of $24,000. A has no other section 1231 or capital gains or losses for 2004.

(ii) Because the stable and the 28 acres used in the business are separate from the dwelling unit, the allocation rules under this paragraph (e) apply and A must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. A determines that $14,000 of the gain is allocable to the non-residential-use portion of the property and that $10,000 of the gain is allocable to the portion of the property used as his residence. A must recognize the $14,000 of gain allocable to the non-residential-use portion of the property ($9,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and $5,000 of which is adjusted net capital gain). A may exclude $10,000 of the gain from the sale of the property.

Example 2. Non-residential use of property not within the dwelling unit and rental of the entire property. (i) In 1998, Taxpayer B buys a property that includes a house, a barn, and 2 acres. B uses the house and 2 acres as her principal residence and the barn for an antiques business. In 2002, B moves out of the house and rents it to tenants. B sells the property in 2004, realizing a gain of $21,000. Between 1998 and 2004, B claims depreciation deductions of $4,800 attributable to the antiques business. Between 2002 and 2004, B claims depreciation deductions of $3,000 attributable to the house. B has no other section 1231 or capital gains or losses for 2004.

(ii) Because the portion of the property used in the antiques business is separate from the dwelling unit, the allocation rules under this paragraph (e) apply. B must allocate basis and amount realized between the portion of the property that she used as her principal residence and the portion of the property that she used for non-residential purposes. B determines that $4,000 of the gain is allocable to the non-residential portion of the property and that $17,000 of the gain is allocable to the portion of the property that she used as her principal residence.

(iii) B must recognize the $4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured section 1250 gain within the meaning of section 1(h)). In addition, the section 121 exclusion does not apply to the gain allocable to the residential portion of the property to the extent of the depreciation adjustments attributable to the residential portion of the property for periods after May 6, 1997 ($3,000). Therefore, B may exclude $14,000 of the gain from the sale of the property.

Example 3. Non-residential use of a separate dwelling unit. (i) In 2002, Taxpayer C buys a 3-story townhouse and converts the basement level, which has a separate entrance, into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property constitutes 2 dwelling units within the meaning of paragraph (e)(2) of this section. C uses the first and second floors of the townhouse as his principal residence and rents the basement level to tenants from 2003 to 2007. C claims depreciation deductions of $2,000 for that period with respect to the basement apartment. C sells the entire property in 2007, realizing gain of $18,000. C has no other section 1231 or capital gains or losses for 2007.

(ii) Because the basement apartment and the upper floors of the townhouse are separate dwelling units, C must allocate the gain between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes under paragraph (e) of this section. After allocating the basis and the amount realized between the residential and non-residential portions of the property, C determines that $6,000 of the gain is allocable to the non-residential portion of the property and that $12,000 of the gain is allocable to the portion of the property used as his residence. C must recognize the $6,000 of gain allocable to the non-residential portion of the property ($2,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and $4,000 of which is adjusted net capital gain). C may exclude $12,000 of the gain from the sale of the property.

Example 4. Separate dwelling unit converted to residential use. The facts are the same as in *Example 3* except that in 2007 C incorporates the basement of the townhouse into his principal residence by eliminating the kitchen and building a new interior stairway to the upper floors. C uses all 3 floors of the townhouse as his principal residence for 2 full years and sells the townhouse in 2010, realizing a gain of $20,000. Under section 121(d)(6) and paragraph (d) of this section, C must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). Because C used the entire 3 floors of the townhouse as his principal residence for 2 of the 5 years preceding the sale of the property, C may exclude the remaining $18,000 of the gain from the sale of the house.

Example 5. Non-residential use within the dwelling unit, property depreciated. Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of $2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of $13,000. D has no other section 1231 or capital gains or losses for 2006. Under section 121(d)(6) and paragraph (d) of this section, D must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). D may exclude the remaining $11,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

Example 6. Non-residential use within the dwelling unit, property not depreciated. The facts are the same as in *Example 5*, except that D is not entitled to claim any depreciation deductions with respect to her business use of the house. D may exclude $13,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

(f) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121–4(j).

§ 1.121–2 Limitations.

(a) *Dollar limitations*—(1) *In general.* A taxpayer may exclude from gross income up to $250,000 of gain from the sale or exchange of the taxpayer's principal residence. A taxpayer is eligible for only one maximum exclusion per principal residence.

(2) *Joint owners.* If taxpayers jointly own a principal residence but file separate returns, each taxpayer may exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of section 121 have otherwise been met.

(3) *Special rules for joint returns*—(i) *In general.* A husband and wife who make a joint return for the year of the sale or exchange of a principal residence may exclude up to $500,000 of gain if—

(A) Either spouse meets the 2-year ownership requirements of § 1.121–1(a) and (c);

(B) Both spouses meet the 2-year use requirements of § 1.121–1(a) and (c); and

(C) Neither spouse excluded gain from a prior sale or exchange of property under section 121 within the last 2 years (as determined under paragraph (b) of this section).

(ii) *Other joint returns.* For taxpayers filing jointly, if either spouse fails to meet the requirements of paragraph (a)(3)(i) of this section, the maximum limitation amount to be claimed by the couple is the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

(4) *Examples.* The provisions of this paragraph (a) are illustrated by the following examples. The examples assume that

§ 1.121–3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Unmarried Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is $256,000. A and B are each eligible to exclude $128,000 of gain because the amount of realized gain allocable to each of them from the sale does not exceed each taxpayer's available limitation amount of $250,000.

Example 2. The facts are the same as in *Example 1*, except that A and B are married taxpayers who file a joint return for the taxable year of the sale. A and B are eligible to exclude the entire amount of realized gain ($256,000) from gross income because the gain realized from the sale does not exceed the limitation amount of $500,000 available to A and B as taxpayers filing a joint return.

Example 3. During 1999, married Taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is $200,000. The gain realized from the sale of W's residence is $300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are each eligible to exclude up to $250,000 of gain from the sale of their individual residences. However, W may not use H's unused exclusion to exclude gain in excess of her limitation amount. Therefore, H and W must recognize $50,000 of the gain realized on the sale of W's residence.

Example 4. Married Taxpayers H and W sell their residence and file a joint return for the year of the sale. W, but not H, satisfies the requirements of section 121. They are eligible to exclude up to $250,000 of the gain from the sale of the residence because that is the sum of each spouse's dollar limitation amount determined on a separate basis as if they had not been married ($0 for H, $250,000 for W).

Example 5. Married Taxpayers H and W have owned and used their principal residence since 1998. On February 16, 2001, H dies. On September 24, 2001, W sells the residence and realizes a gain of $350,000. Pursuant to section 6013(a)(3), W and H's executor make a joint return for 2001. All $350,000 of the gain from the sale of the residence may be excluded.

Example 6. Assume the same facts as *Example 5*, except that W does not sell the residence until January 31, 2002. Because W's filing status for the taxable year of the sale is single, the special rules for joint returns under paragraph (a)(3) of this section do not apply and W may exclude only $250,000 of the gain.

(b) *Application of section 121 to only 1 sale or exchange every 2 years*—(1) *In general.* Except as otherwise provided in § 1.121–3 (relating to the reduced maximum exclusion), a taxpayer may not exclude from gross income gain from the sale or exchange of a principal residence if, during the 2-year period ending on the date of the sale or exchange, the taxpayer sold or exchanged other property for which gain was excluded under section 121. For purposes of this paragraph (b)(1), any sale or exchange before May 7, 1997, is disregarded.

(2) *Example.* The following example illustrates the rules of this paragraph (b). The example assumes that § 1.121–3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer A owns a townhouse that he uses as his principal residence for 2 full years, 1998 and 1999. A buys a house in 2000 that he owns and uses as his principal residence. A sells the townhouse in 2002 and excludes gain realized on its sale under section 121. A sells the house in 2003. Although A meets the 2-year ownership and use requirements of section 121, A is not eligible to exclude gain from the sale of the house because A excluded gain within the last 2 years under section 121 from the sale of the townhouse.

(c) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121–4(j).

§ 1.121–3 Reduced maximum exclusion for taxpayers failing to meet certain requirements.

(a) *In general.* In lieu of the limitation under section 121(b) and § 1.121–2, a reduced maximum exclusion limitation may be available for a taxpayer who sells or exchanges property used as the taxpayer's principal residence but fails to satisfy the ownership and use requirements described in § 1.121–1(a) and (c) or the 2-year limitation described in § 1.121–2(b).

(b) through (f) **[Reserved]**. For further guidance, see § 1.121–3T(b) through (f).

(g) *Computation of reduced maximum exclusion.* (1) The reduced maximum exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

(2) *Examples.* The following examples illustrate the rules of this paragraph (g):

Example 1. Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under section 121 on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to $125,000 of the gain from the sale of her house (12/24 x $250,000).

Example 2. (i) Taxpayer H owns a house that he has used as his principal residence since 1996. On January 15, 1999, H and W marry and W begins to use H's house as her principal residence. On January 15, 2000, H sells the house due to a change in W's place of employment. Neither H nor W has excluded gain under section 121 on a prior sale or exchange of property within the last 2 years.

(ii) Because H and W have not each used the house as their principal residence for at least 2 years during the 5-year period preceding its sale, the maximum dollar limitation amount that may be claimed by H and W will not be $500,000, but the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. (See § 1.121–2(a)(3)(ii).)

(iii) H is eligible to exclude up to $250,000 of gain because he meets the requirements of section 121. W is not eligible to exclude the maximum dollar limitation amount. Instead, because the sale of the house is due to a change in place of employment, W is eligible to claim a reduced maximum exclusion of up to $125,000 of the gain (365/730 x $250,000). Therefore, H and W are eligible to exclude up to $375,000 of gain ($250,000 + $125,000) from the sale of the house.

(h) **[Reserved]**. For further guidance, see § 1.121–3T(h).

(i) through (k) **[Reserved]**.

(l) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121–4(j).

§ 1.121–4 Special rules.

(a) *Property of deceased spouse*—(1) *In general.* For purposes of satisfying the ownership and use requirements of section 121, a taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if—

(i) The taxpayer's spouse is deceased on the date of the sale or exchange of the property; and

(ii) The taxpayer has not remarried at the time of the sale or exchange of the property.

(2) *Example.* The provisions of this paragraph (a) are illustrated by the following example. The example assumes that § 1.121–3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer H has owned and used a house as his principal residence since 1987. H and W marry on July 1, 1999, and from that date they use H's house as their principal residence. H dies on August 15, 2000, and W inherits the property. W sells the property on September 1, 2000, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of section 121 because W's period of ownership and use includes the period that H owned and used the property before death.

(b) *Property owned by spouse or former spouse*—(1) *Property transferred to individual from spouse or former spouse.* If a taxpayer obtains property from a spouse or former spouse in a transaction described in section 1041(a), the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property.

(2) *Property used by spouse or former spouse.* A taxpayer is treated as using property as the taxpayer's principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in section 71(b)(2)), provided that the spouse or former spouse uses the property as his or her principal residence.

(c) *Tenant-stockholder in cooperative housing corporation.* A taxpayer who holds stock as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)) may be eligible to exclude gain under section 121 on the sale or exchange of the stock. In determining whether the taxpayer meets the requirements of section 121, the ownership requirements are applied to the holding of the stock and the use requirements are applied to the house or apartment that the taxpayer is entitled to occupy by reason of the taxpayer's stock ownership.

(d) *Involuntary conversions*—(1) *In general.* For purposes of section 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of the property.

(2) *Application of section 1033.* In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property used as the taxpayer's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from the taxpayer's gross income under section 121.

(3) *Property acquired after involuntary conversion.* If the basis of the property acquired as a result of an involuntary conversion is determined (in whole or in part) under section 1033(b) (relating to the basis of property acquired through an involuntary conversion), then for purposes of satisfying the requirements of section 121, the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any period of time that the taxpayer owned and used the converted property as the taxpayer's principal residence.

(4) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

Example. (i) On February 18, 1999, fire destroys Taxpayer A's house which has an adjusted basis of $80,000. A had owned and used this property as her principal residence for 20 years prior to its destruction. A's insurance company pays A $400,000 for the house. A realizes a gain of $320,000 ($400,000 - $80,000). On August 27, 1999, A purchases a new house at a cost of $100,000.

(ii) Because the destruction of the house is treated as a sale for purposes of section 121, A will exclude $250,000 of the realized gain from A's gross income. For purposes of section 1033, the amount realized is then treated as being $150,000 ($400,000 - $250,000) and the gain realized is $70,000 ($150,000 amount realized - $80,000 basis). A elects under section 1033 to recognize only $50,000 of the gain ($150,000 amount realized - $100,000 cost of new house). The remaining $20,000 of gain is deferred and A's basis in the new house is $80,000 ($100,000 cost - $20,000 gain not recognized).

(iii) A will be treated as owning and using the new house as A's principal residence during the 20-year period that A owned and used the destroyed house.

(e) *Sales or exchanges of partial interests*—(1) *Partial interests other than remainder interests*—(i) *In general.* Except as provided in paragraph (e)(2) of this section (relating to sales or exchanges of remainder interests), a taxpayer may apply the section 121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is less than the taxpayer's entire interest if the interest sold or exchanged includes an interest in the dwelling unit. For rules relating to the sale or exchange of vacant land, see § 1.121–1(b)(3).

(ii) *Limitations*—(A) *Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the partial interests. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121–2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) *Sale or exchange of more than one principal residence in 2-year period.* For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

(2) *Sales or exchanges of remainder interests*—(i) *In general.* A taxpayer may elect to apply the section 121 exclusion to gain from the sale or exchange of a remainder interest in the taxpayer's principal residence.

(ii) *Limitations*—(A) *Sale or exchange of any other interest.* If a taxpayer elects to exclude gain from the sale or exchange of a remainder interest in the taxpayer's principal residence, the section 121 exclusion will not apply to a sale or exchange of any other interest in the residence that is sold or exchanged separately.

(B) *Sales or exchanges to related parties.* This paragraph (e)(2) will not apply to a sale or exchange to any person that bears a relationship to the taxpayer that is described in section 267(b) or 707(b).

(iii) *Election.* The taxpayer makes the election under this paragraph (e)(2) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the remainder interest in the taxpayer's gross income. A taxpayer may make or revoke the election at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(3) *Example.* The provisions of this paragraph (e) are illustrated by the following example:

Example. In 1991, Taxpayer A buys a house that A uses as his principal residence. In 2004, A's friend B moves into A's house and A sells B a 50% interest in the house realizing a gain of $136,000. A may exclude the $136,000 of gain. In 2005, A sells his remaining 50% interest in the home to B realizing a gain of $138,000. A may exclude $114,000 ($250,000 - $136,000 gain previously excluded) of the $138,000 gain from the sale of the remaining interest.

(f) *No exclusion for expatriates.* The section 121 exclusion will not apply to any sale or exchange by an individual if the provisions of section 877(a) (relating to the treatment of expatriates) applies to the individual.

(g) *Election to have section not apply.* A taxpayer may elect to have the section 121 exclusion not apply to a sale or exchange of property. The taxpayer makes the election by filing a return for the taxable year of the sale or exchange that includes the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. A taxpayer may make an election under this paragraph (g) to have section 121 not apply (or revoke an election to have section 121 not apply) at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(h) *Residences acquired in rollovers under section 1034.* If a taxpayer acquires property in a transaction that qualifies under section 1034 (section 1034 property) for the nonrecognition of gain realized on the sale or exchange of another property and later sells or exchanges such property, in determining the period of the taxpayer's ownership and use of the property under section 121 the taxpayer may include the periods that the taxpayer owned and used the section 1034 property as the taxpayer's principal residence (and each prior residence taken into account under section 1223(7) in determining the holding period of the section 1034 property).

(i) **[Reserved]**.

(j) *Election to apply regulations retroactively.* Taxpayers who would otherwise qualify under §§ 1.121–1 through 1.121–4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002, but on or after May 7, 1997, may elect to apply §§ 1.121–1 through 1.121–4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) *Audit protection.* The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002, but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG–105235–99, 2000–2 C.B. 447) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

(l) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions retroactively, see paragraph (j) of this section.

§ 1.121–5 [Removed].

Par. 3. Section 1.121–5 is removed.

Par. 4. Section 1.1398–3 is added to read as follows:

§ 1.1398–3 Treatment of section 121 exclusion in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

(c) *Estate succeeds to exclusion upon commencement of case.* The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) *Effective date.* This section is applicable for sales or exchanges on or after December 24, 2002.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 11, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 23, 2002, 8:45 a.m., and published in the issue of the Federal Register for December 24, 2002, 67 F.R. 78358)

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26 CFR 1.121–3T: Reduced minimum exclusion for taxpayers failing to meet certain requirements (temporary).

T.D. 9031

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence in the case of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain from the sale or exchange of a principal residence within the

preceding two years. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–138882–02) on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective December 24, 2002.

Applicability Date: For dates of applicability, see § 1.121–3T(l).

FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 121(c) relating to the exclusion of gain from the sale or exchange of the principal residence of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years.

Under section 121(a), a taxpayer may exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange. Section 121(b)(3) allows the taxpayer to apply the maximum exclusion to only one sale or exchange during the two-year period ending on the date of the sale or exchange. Section 121(c) provides that a taxpayer who fails to meet any of these conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced maximum amount.

On October 10, 2000, a notice of proposed rulemaking (REG–105235–99, 2000–44 I.R.B. 447) under section 121 was published in the **Federal Register** (65 FR 60136). The proposed regulations did not define change in place of employment, health, or unforeseen circumstances for purposes of the reduced maximum exclusion. Comments were specifically requested regarding what circumstances should qualify as unforeseen. A public hearing was held on January 26, 2001.

The IRS and Treasury Department received numerous comments regarding the reduced maximum exclusion and have concluded that many of these comments should be adopted. However, because the rules formulated in response to these comments are extensive, the IRS and Treasury Department have concluded that the rules relating to the reduced maximum exclusion should be issued as proposed and temporary regulations to provide the public with adequate notice and opportunity to comment. Final regulations under section 121 addressing provisions other than the reduced maximum exclusion are set forth in T.D. 9030 on page 495 of this Bulletin.

Explanation of Provisions

1. *General Provisions*

Under the temporary regulations, a reduced maximum exclusion limitation is available to a taxpayer who has sold or exchanged property owned and used as the taxpayer's principal residence for less than two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years. This reduced maximum exclusion applies only if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances. A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. The taxpayer's primary reason for the sale or exchange is determined based on the facts and circumstances. The temporary regulations provide a list of factors that may be relevant in determining the taxpayer's primary reason. These factors are suggestive only. No single fact or particular combination of facts is determinative of the taxpayer's entitlement to the reduced maximum exclusion.

In addition, for each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors. If a safe harbor applies, the taxpayer's primary reason for the sale or exchange is deemed to be a change in place of employment, health, or unforeseen circumstances.

2. *Change in Place of Employment*

The temporary regulations provide that a sale or exchange is by reason of a change in place of employment if the taxpayer's primary reason for the sale or exchange is a change in the location of the employment of a qualified individual. *Employment* is defined as the commencement of employment with a new employer, the continuation of employment with the same employer, or the commencement or continuation of self-employment. A *qualified individual* is defined as the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer.

The temporary regulations adopt a safe harbor, suggested by commentators, that provides that the primary reason for the sale or exchange is deemed to be a change in place of employment if the new place of employment of a qualified individual is at least fifty miles farther from the residence sold or exchanged than was the former place of employment. If the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged must be at least fifty miles. This standard is derived from section 217(c)(1) relating to the moving expense deduction. The safe harbor applies only if the change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence. If a sale or exchange does not satisfy this safe harbor, a taxpayer may still qualify for the reduced maximum exclusion by reason of a change in place of employment if the facts and circumstances indicate that a change in place of employment is the primary reason for the sale or exchange.

3. *Sale or Exchange by Reason of Health*

Commentators proposed that, for purposes of determining whether a sale or exchange is by reason of health, the regulations adopt standards similar to those for the deductibility of medical expenses under section 213(a). Commentators also suggested that the regulations provide that the reduced maximum exclusion by reason of health apply to sales and exchanges due to (1) advanced age-related infirmities, (2) the taxpayer's need to move in order to care for a family member, (3) severe allergies, and (4) emotional problems.

In response to these comments, the temporary regulations provide the general rule that a sale or exchange is by reason of health if the taxpayer's primary reason for the sale or exchange is (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

One commentator suggested that the regulations establish a safe harbor allowing a taxpayer to claim a reduced maximum exclusion if the taxpayer obtains documentation of a specific medical condition from a licensed physician. The temporary regulations provide a safe harbor that the primary reason for the sale or exchange is deemed to be health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health.

For purposes of the reduced maximum exclusion by reason of health, the term *qualified individual* includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, a person whose principal place of abode is in the same household as the taxpayer, and certain family members of these individuals. The definition of qualified individual in the case of health is broader than the definition that applies to the exclusions by reason of change in place of employment and unforeseen circumstances to encompass taxpayers who sell or exchange their residence in order to care for sick family members.

4. *Sale or Exchange by Reason of Unforeseen Circumstances*

The temporary regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

Many commentators provided suggestions regarding circumstances that should qualify as unforeseen. A large number of commentators suggested that unforeseen circumstances should encompass divorce or the termination of a permanent residential relationship. Others suggested that unforeseen circumstances should include death, birth, marriage, bankruptcy, the loss of employment, incarceration, admission to an institution of higher learning, natural and man-made disasters, involuntary conversions, and a substantial increase in medical or living expenses leading to a significant change in economic circumstances. One commentator suggested that any delay of over three years in selling the residence due to a decline in the real estate market should be deemed an unforeseen circumstance. A few commentators suggested that unforeseen circumstances should include unfavorable changes affecting the desirability of the property, such as environmental problems, zoning-law changes, slovenly neighbors, and serious nuisance or safety concerns.

The temporary regulations adopt many of these suggestions as safe harbors. A taxpayer's primary reason for the sale or exchange is deemed to be unforeseen circumstances if one of the safe harbor events occurs during the taxpayer's ownership and use of the property. The safe harbor events include the involuntary conversion of the residence, a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, and, in the case of a qualified individual: (1) death, (2) the cessation of employment as a result of which the individual is eligible for unemployment compensation, (3) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, (4) divorce or legal separation under a decree of divorce or separate maintenance, and (5) multiple births resulting from the same pregnancy. The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability or in a ruling directed to a specific taxpayer. A taxpayer who does not qualify for a safe harbor may demonstrate that the primary reason for the sale or exchange is unforeseen circumstances, under a facts and circumstances test.

For purposes of the reduced maximum exclusion by reason of unforeseen circumstances, a *qualified individual* includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, and a person whose principal place of abode is in the same household as the taxpayer.

The regulations include examples illustrating the application of the safe harbors and the facts and circumstances test.

5. *Election to Apply Regulations Retroactively*

The regulations provide that taxpayers who would otherwise qualify under these temporary regulations to exclude gain from a sale or exchange that occurred before the effective date of the regulations but on or after May 7, 1997, may elect to apply all of the provisions of the temporary regulations to the sale or exchange. A taxpayer may make the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply all of the provisions of these regulations for any years for which the period of limitations under section 6511 has not expired by filing an amended return.

6. *Audit Protection*

The temporary regulations provide that the IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of these regulations but on or after May 7, 1997, qualifies for the reduced maximum exclusion under section 121(c) if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121(c) and if the sale or exchange otherwise qualifies under section 121.

7. *Effective Date*

These temporary regulations apply to sales and exchanges on or after December 24, 2002.

Special Analyses

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

U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking, REG–138882–02, on page 522 of this Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.121–3T is added to read as follows:

§ 1.121–3T Reduced maximum exclusion for taxpayers failing to meet certain requirements (temporary).

(a) [**Reserved**]. For further guidance, see § 1.121–3(a).

(b) *Primary reason for sale or exchange.* In order for a taxpayer to claim a reduced maximum exclusion under section 121(c), the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment (within the meaning of paragraph (c) of this section), health (within the meaning of paragraph (d) of this section), or unforeseen circumstances (within the meaning of paragraph (e) of this section). Whether the requirements of this section are satisfied depends upon all the facts and circumstances. If the taxpayer qualifies for a safe harbor described in this section, the taxpayer's primary reason is deemed to be a change in place of employment, health, or unforeseen circumstances. If the taxpayer does not qualify for a safe harbor, factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which—

(1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

(2) The suitability of the property as the taxpayer's principal residence materially changes;

(3) The taxpayer's financial ability to maintain the property materially changes;

(4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;

(5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

(6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(c) *Sale or exchange by reason of a change in place of employment*—(1) *In general.* A sale or exchange is by reason of a change in place of employment if, in the case of a qualified individual described in paragraph (f) of this section, the primary reason for the sale or exchange is a change in the location of the individual's employment.

(2) *Distance safe harbor.* The primary reason for the sale or exchange is deemed to be a change in place of employment (within the meaning of paragraph (c)(1) of this section) if—

(i) The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and

(ii) The individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged is at least 50 miles.

(3) *Employment.* For purposes of this paragraph (c), *employment* includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. A is unemployed and owns a townhouse that she has owned and used as her principal residence since 2002. In 2003, A obtains a job that is 54 miles from her townhouse, and she sells the townhouse. Because the distance between A's new place of employment and the townhouse is at least 50 miles, the sale is within the safe harbor of paragraph (c)(2) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. B is an officer in the United States Air Force stationed in Florida. B purchases a house in Florida in 2001. In May 2002, B moves out of his house to take a 3-year assignment in Germany. B sells his house in January 2003. Because B's new place of employment in Germany is at least 50 miles farther from the residence sold than is B's former place of employment in Florida, the sale is within the safe harbor of paragraph (c)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. C is employed by Employer R at R's Philadelphia office. C purchases a house in February 2001 that is 35 miles from R's Philadelphia office. In May 2002, C begins a temporary assignment at R's Wilmington office that is 72 miles from C's house, and moves out of the house. In June 2004, C is assigned to work in R's London office, and as a result, sells her house in August 2004. The sale of the house is not within the safe harbor of paragraph (c)(2) of this section by reason of the change in place of employment from Philadelphia to Wilmington because the Wilmington office is not 50 miles farther from C's house than is the Philadelphia office. Furthermore, the sale is not within the safe harbor by reason of the change in place of employment to London because C is not using the house as her principal residence when she moves to London. However, C is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in C's place of employment.

Example 4. In July 2002, D buys a condominium that is 5 miles from her place of employment and uses it as her principal residence. In February 2003, D, who works as an emergency medicine physician, obtains a job that is located 51 miles from D's condominium. D may be called in to work unscheduled hours and, when called, must be able to arrive at work quickly. Therefore, D sells her condominium and buys a townhouse that is 4 miles from her new place of employment. Because D's new place of employment is only 46 miles farther from the condominium than is D's former place of employment, the sale is not within the safe harbor of paragraph (c)(2) of this section. However, D is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in D's place of employment.

(d) *Sale or exchange by reason of health*—(1) *In general.* A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual described in paragraph (f) of this section, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

(2) *Physician's recommendation safe harbor.* The primary reason for the sale or exchange is deemed to be health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health (as defined in paragraph (d)(1) of this section).

(3) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. In 2002, A buys a house that she uses as her principal residence. A is injured in an accident and is unable to care for herself. As a result, A sells her house in 2003 and moves in with her daughter so that the daughter can provide the care that A requires as a result of her injury. Because, under the facts and circumstances, the primary reason for the sale of A's house is A's health, A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H's father has a chronic disease. In 2002, H and W purchase a house that they use as their principal residence. In 2003, H and W sell their house in order to move into the house of H's father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of H's father, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. H and W purchase a house in 2002 that they use as their principal residence. Their son suffers from a chronic illness that requires regular medical care. Later that year, their doctor recommends that their son begin a new treatment that is available at a medical facility 100 miles away from their residence. In 2003, H and W sell their house to be closer to the medical facility. Because, under the facts and circumstances, the primary reason for the sale is to facilitate the treatment of their son's chronic illness, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B, who has chronic asthma, purchases a house in Minnesota in 2002 that he uses as his principal residence. B's doctor tells B that moving to a warm, dry climate would mitigate B's asthma symptoms. In 2003, B sells his house and moves to Arizona to relieve his asthma symptoms. The sale is within the safe harbor of paragraph (d)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2002, H and W purchase a house in Michigan that they use as their principal residence. H's doctor tells H that he should get more exercise, but H is not suffering from any disease that can be treated or mitigated by exercise. In 2003, H and W sell their house and move to Florida so that H can increase his general level of exercise by playing golf year-round. Because the sale of the house is merely beneficial to H's general health, the sale of the house is not by reason of H's health. H and W are not entitled to claim a reduced maximum exclusion under section 121(c)(2).

(e) *Sale or exchange by reason of unforeseen circumstances*—(1) *In general.* A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

(2) *Specific event safe harbors.* The primary reason for the sale or exchange is deemed to be unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence—

(i) The involuntary conversion of the residence;

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h));

(iii) In the case of a qualified individual described in paragraph (f) of this section—

(A) Death;

(B) The cessation of employment as a result of which the individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy; or

(iv) An event determined by the Commissioner to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.

(3) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. In 2003, A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H works as a teacher and W works as a pilot. In 2003, H and W buy a house that they use as their principal residence. Later that year, W is furloughed from her job for six months. H and W are unable to pay their mortgage during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. In 2003, H and W buy a two-bedroom condominium that they use as their principal residence. In 2004, W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B buys a condominium in 2003 and uses it as his principal residence. B's monthly condominium fee is $X. Three months after B moves into the condominium, the condominium association decides to replace the building's roof and heating system. Six months later, B's monthly condominium fee doubles. B sells the condominium in 2004 because B is unable to pay the new condominium fee along with the monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003, C buys a house that he uses as his principal residence. The property is located on a heavily trafficked road. C sells the property in 2004 because the traffic is more disturbing than he expected. C is not entitled to claim a reduced maximum exclusion under section 121(c)(2) because the safe harbors of paragraph (e)(2) of this section do not apply and, under the facts and circumstances, the traffic is not an unforeseen circumstance.

Example 6. In 2003, D and her fiancé E buy a house and live in it as their principal residence. In 2004, D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

(f) *Qualified individual.* For purposes of this section, *qualified individual* means—

(1) The taxpayer;

(2) The taxpayer's spouse;

(3) A co-owner of the residence;

(4) A person whose principal place of abode is in the same household as the taxpayer; or

(5) For purposes of paragraph (d) of this section, a person bearing a relationship

specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.

(g) [**Reserved**]. For further guidance, see § 1.121–3(g).

(h) *Election to apply regulations retroactively.* Taxpayers who would otherwise qualify under this section to exclude gain from a sale or exchange before December 24, 2002, but on or after May 7, 1997, may elect to apply all of the provisions of this section for any years for which the period of limitations under section 6511 has not expired. The taxpayer makes the election under this paragraph (h) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply all the provisions of this section for any years for which the period of limitations under section 6511 has not expired by filing an amended return.

(i) through (j) [**Reserved**]. See § 1.121–3(i) through (j).

(k) *Audit protection.* The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence that occurred before December 24, 2002, but on or after May 7, 1997, qualifies for the reduced maximum exclusion under section 121(c) if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121(c) and if the sale or exchange otherwise qualifies under section 121.

(l) *Effective date.* For the applicability of this section, see § 1.121–3(l).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 11, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 23, 2002, 8:45 a.m., and published in the issue of the Federal Register for December 24, 2002, 67 F.R. 78367)

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The December 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 2002.

Rev. Rul. 2003–21

The following Department Store Inventory Price Indexes for December 2002 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, December 31, 2002.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

	Groups	Dec. 2001	Dec. 2002	Percent Change from Dec. 2001 to Dec. 2002[1]
1.	Piece Goods	484.4	465.6	-3.9
2.	Domestics and Draperies	591.0	561.8	-4.9
3.	Women's and Children's Shoes	639.8	640.1	0.0
4.	Men's Shoes	889.1	888.0	-0.1
5.	Infants' Wear	623.4	612.4	-1.8
6.	Women's Underwear	569.0	536.7	-5.7
7.	Women's Hosiery	352.9	345.3	-2.2
8.	Women's and Girls' Accessories	557.4	540.3	-3.1
9.	Women's Outerwear and Girls' Wear	365.4	356.4	-2.5
10.	Men's Clothing	564.3	550.6	-2.4
11.	Men's Furnishings	595.3	584.7	-1.8
12.	Boys' Clothing and Furnishings	473.6	446.2	-5.8
13.	Jewelry	895.8	855.4	-4.5

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Dec. 2001	Dec. 2002	Percent Change from Dec. 2001 to Dec. 2002[1]
14. Notions	817.8	793.2	-3.0
15. Toilet Articles and Drugs	975.7	967.5	-0.8
16. Furniture and Bedding	625.9	623.8	-0.3
17. Floor Coverings	625.2	596.3	-4.6
18. Housewares	758.9	734.4	-3.2
19. Major Appliances	226.7	219.4	-3.2
20. Radio and Television	51.9	47.3	-8.9
21. Recreation and Education[2]	87.9	84.3	-4.1
22. Home Improvements[2]	124.2	125.8	1.3
23. Auto Accessories[2]	110.4	111.3	0.8
Groups 1 – 15: Soft Goods	575.7	560.7	-2.6
Groups 16 – 20: Durable Goods	417.1	402.4	-3.5
Groups 21 – 23: Misc. Goods[2]	97.3	95.2	-2.2
Store Total[3]	517.2	503.0	-2.7

[1]Absence of a minus sign before the percentage change in this column signifies a price increase.

[2]Indexes on a January 1986=100 base.

[3]The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

Section 3406.—Backup Withholding

26 CFR 31.3406(j)–1T: Taxpayer Identification Number (TIN) matching program (temporary).

T.D. 9041

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 31

Taxpayer Identification Number (TIN) Matching Program

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 3406 relating to the IRS Taxpayer Identification Number (TIN) Matching Program. These final and temporary regulations affect payors, and their authorized agents, and provide guidance necessary to comply with the law. The text of the temporary regulations also serves as the text of the proposed regulations (REG–116641–01) set forth on page 518 of this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective January 31, 2003.

Applicability Date: For dates of applicability, see §§ 31.3406(j)–1(f) and 31.3406(j)–1T(f).

FOR FURTHER INFORMATION CONTACT: Donna Welch at (202) 622–4910.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Employment Tax Regulations (26 CFR part 31) relating to the IRS TIN Matching Program.

Section 3406(a)(1) requires a payor to withhold on any reportable payment (as defined in section 3406(b)(1)) in certain situations, including if (1) the payee fails to furnish his TIN to the payor as required or (2) the Secretary notifies the payor that the

TIN furnished by the payee is incorrect. Section 3406(i) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 3406.

Regulations under section 3406(i) provide that the Commissioner has the authority to establish TIN matching programs through revenue procedures or other appropriate guidance. Under the regulations, a payor participating in a TIN matching program may, before filing information returns with respect to reportable payments, contact the IRS with respect to the TIN furnished by the payee. The regulations provide that the IRS will inform the payor whether or not the name/TIN combination furnished by the payee matches a name/TIN combination maintained for the TIN matching program.

Pursuant to the authority in the regulations, the IRS issued Rev. Proc. 97–31, 1997–1 C.B. 703, and implemented a TIN matching program for Federal agency payors. The IRS is now issuing a second revenue procedure pursuant to that authority (as amended by these temporary regulations). This revenue procedure will expand the scope of the IRS TIN Matching Program to allow all payors (and not merely Federal agency payors), as well as payors' authorized agents, to participate in TIN matching. In addition, the IRS and the Treasury Department expect to issue additional published guidance that will allow payment card organizations to act on behalf of cardholder/payors for purposes of soliciting, collecting, and validating merchant/payees' names and TINs through TIN matching if certain requirements are met.

Explanation of Provisions

These regulations specifically authorize a payor's authorized agent to participate in TIN matching by providing that, for purposes of the TIN matching program, the term *payor* includes an agent designated by the payor to participate in TIN matching on behalf of the payor.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking (REG–116641–01) published in this issue of the Bulletin. Pursuant to section 7805(f), the temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 is amended by adding an entry in numerical order to read in part as follows:

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

Section 31.3406(j)–1T also issued under 26 U.S.C. 3406(i). * * *

Par. 2. Section 31.3406(j)–1 is amended by revising paragraphs (a) and (f) to read as follows:

(a) [Reserved]. For further guidance, see § 31.3406(j)–1T(a).

* * * * *

(f) [Reserved]. For further guidance, see § 31.3406(j)–1T(f).

Par. 3. Section 31.3406(j)–1T is added to read as follows:

§ 31.3406(j)–1T Taxpayer Identification Number (TIN) matching program (temporary).

(a) *The matching program.* Under section 3406(i), the Commissioner has the authority to establish Taxpayer Identification Number (TIN) matching programs. The Commissioner may prescribe in a revenue procedure (see § 601.601(d)(2) of this chapter) or other appropriate guidance the scope and the terms and conditions of participating in any TIN matching program. In general, under a matching program, prior to filing information returns with respect to reportable payments as defined in section 3406(b)(1), a payor of those reportable payments who is entitled to participate in the matching program may contact the Internal Revenue Service (IRS) with respect to the TIN furnished by a payee who has received or is likely to receive a reportable payment. The IRS will inform the payor whether or not a name/TIN combination furnished by the payee matches a name/TIN combination maintained in the data base utilized for the particular matching program. For purposes of this section, the term *payor* includes an agent designated by the payor to participate in TIN matching on the payor's behalf.

(b) through (e) [Reserved]. For further guidance, see § 31.3406(j)–1(b) through (e).

(f) *Effective date.* The provisions of this section are applicable on or after June, 18, 1997, except the last sentence in paragraph (a) of this section which is applicable on January 31, 2003. The applicability of this section expires on January 30, 2006.

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

Approved January 17, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 30, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 31, 2003, 68 F.R. 4922)

Section 6654.—Failure by Individual to Pay Estimated Income Tax

26 CFR 1.6654–2: Exceptions to imposition of the addition to the tax in the case of individuals.

Estimated tax penalty safe harbor. This ruling addresses the application of section 6654(d)(1)(B)(ii) of the Code where an individual filed a late original return for the preceding year.

Rev. Rul. 2003–23

PURPOSE

This revenue ruling provides guidance on whether the Internal Revenue Service will impose an addition to tax for the underpayment of estimated tax under section 6654(a) of the Internal Revenue Code as to an individual whose timely estimated tax payments for the current taxable year meet the requirement of section 6654(d)(1)(B)(ii) based on tax shown on a late-filed return for the preceding taxable year.

LAW AND ANALYSIS

Section 6654(a) provides for an addition to tax for the taxable year if there is an underpayment of estimated tax by an individual.

Section 6654(b)(1) provides that the amount of the underpayment shall be the excess of the required installment over the amount of the installment paid on or before the due date for the installment.

Section 6654(c)(1) provides that there shall be four required installments for each taxable year.

Section 6654(d)(1)(A) provides generally that the amount of any required installment shall be 25 percent of the required annual payment. Section 6654(d)(1)(B) provides that the term "required annual payment" means the lesser of (i) 90 percent of tax shown on the return for the taxable year (or, if no return is filed, 90 percent of tax for such year), or (ii) 100 percent of tax shown on the return of the individual for the preceding taxable year. If the adjusted gross income shown on the return of the individual for the preceding taxable year exceeds $150,000, the required annual payment is 110 percent of tax shown on such return. *See* section 6654(d)(1)(C). If the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year, the required annual payment is 90 percent of tax shown on the return for the current taxable year. *See* section 6654(d)(1)(B).

Section 1.6654–2(a) of the Income Tax Regulations provides that the addition to tax under section 6654 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the least of the amounts in § 1.6654–2(a).

Section 1.6654–2(a)(1) echoes section 6654(d)(1)(B)(ii) and describes the amount that is required to be paid on or before the date prescribed for payment if the required annual installment is based on tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year.

The only nonmonetary limitations on the application of section 6654(d)(1)(B)(ii) are the two stated above. Neither the Code nor the regulations require that the individual have filed the preceding taxable year's return by the due date. Similarly, neither the Code nor the regulations provide that section 6654(d)(1)(B)(ii) will not apply if the individual filed the return for the preceding taxable year after the due date.

HOLDING

Accordingly, when an individual files a late return for the preceding taxable year and pays as required the installments properly predicated on tax shown on that return, the Service will not impose the addition to tax under section 6654(a) for the underpayment of estimated tax for the current taxable year.

EFFECT ON OTHER REVENUE RULING(S)

None.

DRAFTING INFORMATION

The principal author of this revenue ruling is Tiffany P. Smith of the Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact Tiffany P. Smith at (202) 622–4910 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Notice 2003–13

This notice provides a proposed revenue procedure that would establish a procedure for a payment card organization to request a determination that it is a Qualified Payment Card Agent (QPCA) for purposes of §§ 3406 and 6724 of the Internal Revenue Code. A QPCA could act on behalf of cardholder/payors in soliciting, collecting, and validating merchants' names, Taxpayer Identification Numbers (TINs) and corporate status and on behalf of merchant/payees in furnishing such information to cardholder/payors. The proposed revenue procedure describes the application procedures for a payment card organization to request a QPCA determination, the requirements that a payment card organization must meet, including the TIN solicitation activities that a payment card organization must undertake, to obtain a QPCA determination and avoid revocation of the determination.

The IRS requests comments on this proposed revenue procedure. Written comments must be received by May 5, 2003. Comments should be submitted to: CC:PA:RU (NOT–122617–02), Room 5526, Internal Revenue Service, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand delivered between the hours of 8:00 AM and 5:00 PM to CC:PA:RU (NOT–122617–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC. Comments may also be transmitted electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2003–13" in the subject line of any electronic communications.

For further information regarding this notice, contact Donna Welch of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. Ms. Welch may be contacted at 202–622–4910 (not a toll-free call).

APPENDIX
(PROPOSED REVENUE PROCEDURE)

SECTION 1. PURPOSE

This revenue procedure establishes a procedure for a payment card organization to request a determination that it is a Qualified Payment Card Agent (QPCA) for purposes of §§ 3406 and 6724 of the Internal Revenue Code. A QPCA may act on behalf of cardholder/payors in soliciting, collecting, and validating merchants' names, TINs and corporate status and on behalf of merchant/payees in furnishing such information to cardholder/payors. Proposed Procedure and Administration Regulations would relieve cardholder/payors from certain TIN solicitation requirements for payments made through a QPCA. Proposed Employment Tax Regulations would also provide an exemption from the backup withholding requirements for payments made to certain merchant/payees through a QPCA.

SECTION 2. BACKGROUND

.01 *Payment card transactions.* A payment card transaction is a transaction in which a cardholder/payor uses a payment card (as defined in section 4.03 of this revenue procedure) to purchase goods or services and a merchant agrees to accept a payment card as a means of obtaining payment. A payment card organization (as defined in section 4.04 of this revenue procedure) sets the standards and provides the mechanism, either directly or indirectly through members and affiliates, for effecting the payment.

.02 *Reporting requirements.* In general, § 6041 requires a person engaged in a trade or business and making a payment in the course of the trade or business of $600 or more during a calendar year of fixed or determinable income to file an information return with the IRS and to furnish an information statement to the payee. Section 1.6041–3(p) of the Income Tax Regulations provides exceptions to these requirements, including, for example, exceptions for payments made to a payee that is a corporation.

Section 6109(a)(2) provides that any payee, with respect to whom a return is required to be made by another person or whose identifying number is required to be shown on a return of another person, must furnish to the other person the identifying number prescribed for securing the proper identification of the payee. Section 6109(a)(3) provides that any person required to make a return with respect to a payee must ask the payee for the identifying number prescribed for securing the proper identification of the payee and must include that number in the return.

.03 *Backup withholding.* Section 3406(a)(1) requires a payor to withhold on reportable payments (as defined in § 3406(b)(1)) if the payee does not provide a TIN to the payor in the manner required or if the Secretary notifies the payor that the TIN furnished by the payee is incorrect or in certain other circumstances. Section 3406(i) provides that the Secretary shall prescribe the regulations necessary or appropriate to carry out the purposes of § 3406.

Section 31.3406(j)–1 of the Employment Tax Regulations provides that the Commissioner has the authority to establish TIN matching programs through revenue procedures or other appropriate guidance. Under the regulations, a payor participating in a TIN matching program may contact the IRS with respect to the TIN furnished by a payee before filing information returns with respect to reportable payments to the payee. The regulations further provide that the IRS will inform the payor whether or not the name/TIN combination furnished by the payee matches a name/TIN combination maintained for the TIN matching program. Section 31.3406(j)–1T of the temporary Employment Tax Regulations provides that an authorized agent, including a QPCA, designated by a payor to participate in TIN matching on the payor's behalf is also permitted to participate in TIN matching. Revenue Procedure 2003–9 issued pursuant to the authority in § 31.3406(j)–1 permits all payors (and authorized agents described in § 31.3406(j)–1T) to participate in TIN matching.

Section 31.3406(g)–1(f) of the proposed Employment Tax Regulations would provide that the backup withholding requirements of section 3406 do not apply to payments made through a QPCA if the payments are made to a qualified payee (as defined in proposed § 31.3406(g)–1(f)(2)(v)) or during a grace period for determining whether the payee is a qualified payee. Section 31.3406(g)–1(f)(3) of the proposed regulations would require a QPCA to notify the cardholder/payor when payments are made to a merchant/payee who is not a qualified payee.

.04 *Information reporting penalties and waivers for reasonable cause.* Section 6721 provides that a payor may be subject to a penalty for failure to file a complete and correct information return. Section 6722 provides that a payor may be subject to a penalty for failure to furnish a complete and correct information statement to a payee. A failure subject to the §§ 6721 and 6722 penalties includes a failure to include correct payee TINs.

Section 6724 provides that the penalties under §§ 6721 and 6722 may be waived if the filer shows that the failure was due to reasonable cause and was not due to willful neglect. Section 301.6724–1(e)(1)(vi)(H) and (f)(5)(vii) of the proposed Procedure and Administration Regulations would provide that a cardholder/payor in a payment card transaction may establish reasonable cause based on its reliance on a QPCA.

SECTION 3. SCOPE

This revenue procedure applies to payment card organizations seeking to act on behalf of cardholder/payors in soliciting, collecting, and validating merchants' names, TINs and corporate status and on behalf of merchant/payees in furnishing such information to cardholder/payors.

SECTION 4. DEFINITIONS

For purposes of this revenue procedure, the following definitions apply:

.01 *Cardholder.* A cardholder is the payor for payments made to a merchant/payee through a payment card.

.02 *Merchant.* A merchant is a payee that has entered into an agreement with a payment card organization, or a member or affiliate, to accept the organization's payment card as payment for goods and services.

.03 *Payment card.* A payment card is a card (or an account) issued by a payment card organization, or one of its members or affiliates, to a cardholder/payor which, upon presentation to a merchant/payee, represents an agreement of the cardholder to pay the merchant through the payment card organization.

.04 *Payment card organization.* A payment card organization is an entity that sets the standards and provides the mechanism, either directly or indirectly through members and affiliates, for effectuating payment between a purchaser and a merchant in a payment card transaction. A payment card organization generally provides such a payment mechanism by issuing payment cards, enrolling merchants as authorized acceptors of payment cards for payment for goods or services, and ensuring the system conducts the transactions in accordance with prescribed standards.

.05 *Qualified Payment Card Agent (QPCA).* A QPCA is a payment card organization that has a current QPCA determination from the IRS. A person acting in its capacity as a QPCA does not act as an agent of the IRS, nor does it have the authority to hold itself out as an agent of the IRS.

SECTION 5. APPLICATION AND REQUIREMENTS FOR QPCA DETERMINATION

.01 *Where to apply for QPCA determination.* A person authorized to act on behalf of a payment card organization may submit a written request for a QPCA determination to the following address:

Internal Revenue Service –
Martinsburg Computing Center
250 Murall Drive, Mail Stop 360
ATTN: TIN Matching Coordinator
Kearneysville, WV 25430

.02 *Content of QPCA application.* A payment card organization requesting a QPCA determination must include the following in its application:

(1) The name, address, and employer identification number of the payment card organization and a description of its business.

(2) The name of the department or office of the payment card organization that will serve as the information contact.

(3) The name of the department or the names and titles of the officers or employees that will be responsible for the performance of the TIN solicitation activities described in section 6.

(4) A list of the systems, business lines, or card products that will be covered by the TIN solicitation activities described in section 6.

(5) An explanation of the account opening procedures and documents the payment card organization uses, or requires its members or affiliates to use, to establish merchant account relationships.

(6) The approximate number and the type of merchants (individuals, corporations, etc.) enrolled by the payment card organization.

(7) An explanation of the payment card organization's systems and controls for—

(a) Obtaining merchant/payee data either directly or indirectly through its members or affiliates or from other sources;

(b) Validating the accuracy of the merchant/payee data;

(c) Ensuring the accuracy and reliability of the merchant/payee data;

(d) Maintaining the merchant/payee data; and

(e) Supplying the merchant/payee data to the cardholder/payor.

.03 *Requirements for QPCA determination.* A payment card organization must meet the following requirements to obtain a QPCA determination:

(1) *Express authorization to act on behalf of cardholder/payors and on behalf of merchant/payees.* The payment card organization must establish that cardholder/payors have expressly authorized it, or its members or affiliates, to act on their behalf in soliciting, collecting, and validating merchants' names and TINs and to assist the cardholders in meeting their information reporting obligations under §§ 6041 and 6041A. The payment card organization must also establish that merchant/payees have expressly authorized it, or its members or affiliates, to act on their behalf in furnishing their names and TINs to cardholders and to assist the merchants in meeting their obligations under § 6109(a)(2).

(2) *TIN solicitation activities.* The payment card organization must establish that

it has, or demonstrate that it will, undertake the TIN solicitation activities described in section 6.

(3) *Reliability of merchant/payee data*. After obtaining the authorizations required by section 5.03(1), the payment card organization must participate in the IRS TIN Matching Program and must demonstrate, based on the TIN matching results, that its merchant/payee data is sufficiently reliable.

SECTION 6. TIN SOLICITATION ACTIVITIES

.01 *Notification and disclosure requirements*. A QPCA must notify the merchant/payees for which it acts as agent that it will obtain the merchant/payees' TINs and corporate status and will provide this information to cardholder/payors to assist cardholders in meeting their information reporting obligations.

A QPCA must notify the cardholder/payors for which it acts as agent that any merchant/payees' names, TINs, and corporate status that the QPCA may furnish may be used by the cardholder solely for purposes of meeting its information reporting obligations.

A QPCA must disclose its status as a QPCA, and any change in that status, to any member or affiliate that issues payment cards, as well as to the merchant/payees and cardholder/payors for which it acts as agent.

.02 *TIN Matching participation*. A QPCA must participate in the IRS TIN Matching Program and must match its merchant/payee data relating to reportable payments with IRS data at least annually. The QPCA must transmit only merchant/payee data that has not previously been validated through IRS TIN Matching.

The QPCA must notify the merchant/payees for which it acts as agent that it will participate in the IRS TIN Matching Program and that, if the merchant/payee provides a TIN to the payment card organization, the TIN may be matched against IRS data.

.03 *Providing merchant/payee data to cardholders*. The QPCA must provide cardholder/payors with merchant/payee data on or before December 31 of the year in which the transaction occurs, or on or before 30 days after the transaction, whichever is later. The QPCA must provide cardholder/payors with the results of its TIN matching participation within 30 days after the payment card organization receives the results.

SECTION 7. OTHER REQUIREMENTS

.01 *Availability of records*. A payment card organization must respond to any reasonable IRS request for inspection of any books and records that relate to the operation of TIN solicitation activity, including, but not limited to, reports, memoranda, budgets, and computer printouts. The payment card organization must allow the IRS reasonable access to the merchant/payee TIN data system, including instruction manuals describing the system.

.02 *Change in information*. The QPCA must promptly notify the IRS of any change in the information described in section 5.

.03 *Confidentiality of information*. The payment card organization must maintain the confidentiality of information obtained through its TIN solicitation activities in accordance with the requirements of § 31.3406(f)–1 of the Employment Tax Regulations. Except as permitted under § 31.3406(f)–1, the payment card organization may not disclose any merchant/payee information to any person other than the cardholder/payor without prior written consent of the merchant/payee. The IRS will treat all information provided by a QPCA as confidential taxpayer return information under § 6103.

SECTION 8. TERM, RENEWALS, AND TERMINATION

.01 *Term and renewal*. In general, a QPCA determination will be effective for three years from the date of the determination. A QPCA may request a renewal of the QPCA determination by submitting an application for renewal to the IRS no earlier than six months and no later than three months before the expiration of the three-year term. In the application for renewal, the QPCA must report any change in the information in the original application. Before renewal of the determination, the IRS may review the QPCA's systems. In addition, the QPCA must demonstrate that the merchant/payee data continues to be reliable. The application for renewal must include the results from participation in the IRS TIN Matching Program during the current three-year term. The IRS will make every effort to issue a decision on a renewal application at least 30 days before the expiration of the current three-year term. In the event that the IRS does not issue a decision on a timely renewal application before the expiration of the existing QPCA determination, the determination will remain in effect until the IRS issues a decision on the renewal application.

.02 *Revocation of determination*. The IRS may revoke a QPCA determination before the expiration of its three-year term if the IRS determines, based on the results of the QPCA's participation in the IRS TIN Matching Program, that the merchant/payee data is not reliable or if the payment card organization fails to meet any of the requirements in section 5, 6, or 7.

SECTION 9. EFFECTIVE DATE

The procedures are proposed to be effective on the date they are published as a final revenue procedure.

Weighted Average Interest Rate Update

Notice 2003–14

Sections 412(b)(5)(B) and 412(1)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(1) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

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

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

The rate of interest on 30-year Treasury Securities for January 2003 is 4.94 percent. Pursuant to Notice 2002–26, 2002–15 I.R.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(1)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

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

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
February	2003	5.51	4.96 to 6.06	4.96 to 6.62

DRAFTING INFORMATION

The principal authors of this notice are Tony Montanaro and Paul Stern of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Montanaro may be reached at 1–202–283–9714 and Mr. Stern may be reached at 1–202–283–9703. The telephone numbers in the preceding sentence are not toll-free.

26 CFR 601.602: Tax Forms and Instructions.
(Also Part 1, §§ 3406; 6109; 31.3406(d)–5.)

Rev. Proc. 2003–9

SECTION 1. PURPOSE

This revenue procedure establishes an expanded Taxpayer Identification Number (TIN) Matching Program (The Program). The Federal Agency TIN Matching Program established by Rev. Proc. 97–31 was limited to Federal agencies and processed data on tapes or cartridges. The Program established by this revenue procedure is an online system open to all payors of "reportable payments" as defined in section 3.06, and their authorized agents as defined in section 3.02.

Until further notice, Federal agencies may match TINs under the procedures of either Rev. Proc. 97–31 or this revenue procedure. However, the Service encourages Federal agencies to use the Program established by this revenue procedure.

The Program permits payors to verify the payee TINs required to be reported on information returns and payee statements. Prior to filing an information return, a Program participant may check the TIN furnished by the payee against the name/TIN combination contained in the Service data base maintained for the Program. The IRS will maintain a separate name/TIN data base specifically for the Program and will inform the payor whether or not the name/TIN combination furnished by the payee matches a name/TIN combination in the data base. The TIN Matching online interactive program will provide the results of up to 25 requests in real time. A bulk file containing up to 100,000 TIN match requests can be processed overnight via a Secure Mailbox. The matching details provided to participating payors will help avoid TIN errors and reduce the number of backup withholding notices required under section 3406(a)(1)(B) of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 Section 3406(a)(1) provides, in part, that the payor shall deduct and withhold income tax from a reportable payment if either—

(1) the payee fails to furnish the payee's TIN to the payor in the required manner, or

(2) the Secretary of the Treasury notifies the payor that the TIN furnished by the payee is incorrect.

.02 Section 31.3406(j)–1(a) of the Employment Tax Regulations provides that the Commissioner has the authority to establish TIN matching programs and may prescribe by revenue procedure or other guidance the scope of and terms and conditions for participating in such programs.

.03 Section 31.3406(j)–1(b) provides that none of the matching details received by a payor through a TIN matching program will constitute a notice regarding an incorrect name/TIN combination under § 31.3406(d)–5(c) for purposes of imposing backup withholding under § 3406(a)(1)(B).

.04 Section 31.3406(j)–1(c) provides that § 3406(f), relating to confidentiality of information, applies to any matching details received by a payor through a TIN matching program. A payor may not take into account any such matching details in determining whether to open or close an account with a payee.

.05 Section 6721 provides that a payor may be subject to a penalty for failure to file a complete and correct information return. Section 6722 provides that a payor may be subject to a penalty for failure to furnish a complete and correct information statement (payee statement) to a payee. Not including the correct payee TIN on an information return or payee statement is a failure subject to the §§ 6721 and 6722 penalties.

.06 Section 6724 provides that the Service may waive the penalties under §§ 6721 and 6722 if the filer (payor) shows that the failure was due to reasonable cause and was not due to willful neglect. The regulations under § 6724 provide that a filer may establish reasonable cause by showing, among other things, that the failure arose due to an event beyond the filer's control.

.07 Section 31.3406(j)–1(d) provides that the Service will not use a payor's decision not to participate in the TIN Matching Program as a basis to assert that the payor lacks reasonable cause under

§ 6724(a) for failure to file a correct information return under § 6721 or to furnish a correct payee statement under § 6722.

SECTION 3. DEFINITIONS

.01 *Participant.* The term "participant" means a person that is either a payor or a payor's authorized agent and that has applied and been accepted to participate in the Program.

.02 *Authorized Agent.* The term "authorized agent" means a person that, with the payor's written authorization, matches name and TIN combinations on behalf of the payor.

.03 *Participating Payor.* The term "participating payor" means a payor that is participating in the Program either on its own behalf or through an authorized agent that is a participant.

.04 *Payee*. The term "payee" means a person with respect to whom a reportable payment, as defined in § 3406(b), has been made or is likely to be made by a participating payor.

.05 *Account.* The term "account" means any account, instrument, or other relationship with a payee (such as a contract) with respect to which a participating payor has made or is likely to make a reportable payment. See § 31.3406(j)–1(e).

.06 *Reportable Payment.* The term "reportable payment" means interest and dividend payments as defined in § 3406(b)(2) and other reportable payments as defined in § 3406(b)(3).

.07 *TIN*. For the purposes of this revenue procedure, the term "TIN" means the taxpayer identification number that a payee is required to furnish to a payor. The TIN may be an Employer Identification Number (EIN), a Social Security Number (SSN), or an Internal Revenue Service Individual Taxpayer Identification Number (ITIN). See § 6109.

.08 *User*. The term "user" means an individual who has registered and received an Internal Revenue Service user account number for the TIN Matching Program.

SECTION 4. SCOPE

This revenue procedure applies to participants accepted in the Program under section 5 of this procedure. Publication 2108, *Specifications for TIN Matching Program,* contains the format and processing specifications for transmitting the name/TIN data and procedures for operation of the Program.

Participating payors may cite a name and TIN match as reasonable cause under § 6724(a), if the Service asserts a penalty under § 6721 or § 6722. The Service will waive the penalty if the participating payor presents documentation of the match in a manner set forth in Publication 2108.

SECTION 5. APPLICATION, REGISTRATION, ACCEPTANCE

.01 *Application to Participate.* A payor or authorized agent may apply to participate in the Program by submitting an application in the form and the manner specified in Publication 2108, *Specifications for TIN Matching Program.* The application must be signed by an individual who can legally bind the applicant.

.02 *Registration.* A participant in the Program may designate one or more individuals who are authorized to access the name/TIN data base on behalf of the participant. A designated individual may access the data base only through an Internal Revenue Service user account and must register with the Internal Revenue Service to obtain a user account and become a user. Registration is accomplished online in the manner specified in Publication 2108. The registrant must provide name, social security number, adjusted gross income from the current or prior year's tax return, and date of birth. The registrant must self-select a user name, password, and PIN. After verifying the information provided by the registrant, the Service will mail a registration notice containing a confirmation number to the registrant's postal address of record.

.03 *Access to System.* A newly registered individual will have limited system access (*e.g.*, to apply for e-file and maintain his or her registration data) until the registrant receives and enters the confirmation number. Upon entering the confirmation number, the registrant may access the system on behalf of a Program participant that has authorized such access by a designation of the registrant under section 5.02.

SECTION 6. REQUIREMENTS FOR PARTICIPATION

Participants in the Program must—

.01 Comply with all requirements of this revenue procedure and Publication 2108;

.02 Transmit only name/TIN combinations relating to accounts (as defined in section 3.05 of this revenue procedure) with respect to which a reportable payment is made, or is likely to be made, on or after the effective date of this revenue procedure;

.03 Transmit only name/TIN combinations that have not been previously transmitted by that participant to the Service for matching;

.04 Maintain the confidentiality of information obtained through TIN solicitation activities in accordance with the requirements of § 31.3406(f)–1 of the Employment Tax Regulations;

.05 Provide the Service with the information necessary to monitor the effectiveness of the Program.

SECTION 7. INQUIRIES

Questions about this TIN Matching Program may be addressed to:

Internal Revenue Service
Martinsburg Computing Center
250 Murall Drive MS 360
Attn: TIN Matching Coordinator
Kearneysville, West Virginia 25430

SECTION 8. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies Revenue Procedure 97–31, 1997–1 C.B. 703, to establish an expanded TIN Matching Program open to all payors of reportable payments and their authorized agents. Until notified otherwise, Federal agencies may continue to match TINs under the procedures set forth in Rev. Proc. 97–31.

SECTION 9. EFFECTIVE DATE

This revenue procedure will be effective upon the IRS issuing a notice announcing the availability of E-Services.

SECTION 10. DRAFTING INFORMATION

The principal author of this revenue procedure is Patricia Manasevit of the Office of the Associate Chief Counsel, Procedure and Administration. For further information regarding this revenue procedure, contact Ms. Manasevit at (202) 622–4910 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking; Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations; and Notice of Public Hearing

Information Reporting and Backup Withholding for Payment Card Transactions

REG–116641–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulations; and notice of public hearing.

SUMMARY: On page 510 of this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9041) relating to the IRS Taxpayer Identification Number (TIN) Matching Program. The text of the temporary regulations published in this issue of the Bulletin serves as the text of this portion of the proposed regulations. This document also contains proposed regulations relating to the information reporting requirements, information reporting penalties, and backup withholding requirements for payment card transactions. These regulations affect payors (and their authorized agents) and payees of certain reportable payments and provide guidance necessary to comply with the law. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by May 1, 2003. Outlines of topics to be discussed at the public hearing scheduled for May 21, 2003, must be received by April 30, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–116641–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–116641–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at *www.irs.gov/regs*. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622–4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by April 1, 2003. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation is in § 31.3406(g)–1(f)(3). This information is required in order for a Qualified Payment Card Agent (QPCA) to notify a cardholder/payor that a merchant/payee is not a qualified payee for purposes of the proposed regulations. This information will alert a cardholder/payor that backup withholding under 3406 may apply. The collection of information is voluntary to obtain a benefit. The likely respondents are business or other for-profit institutions.

Estimated total annual reporting burden: 11,750,000 hours.

Estimated average annual burden hours per respondent: 5,875 hours.

Estimated number of respondents: 2,000.

Estimated annual frequency of responses: monthly.

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

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

Background

1. *Summary*

This document contains proposed amendments to 26 CFR part 31 relating to backup withholding under section 3406 of the Internal Revenue Code and proposed amendments to 26 Part 301 relating to waivers under section 6724 of information reporting penalties under sections 6721 and 6722.

Temporary regulations in this issue of the Bulletin provide that, for purposes of the IRS TIN Matching Program, the term *payor* includes an agent designated by the payor to participate in TIN matching on behalf of the payor. The text of those temporary regulations also serves as the text of proposed amendments to § 31.3406(j)–1(a) of the regulations. The preamble to the temporary regulations explains the proposed amendments to § 31.3406(j)–1(a).

2. *Information Reporting and Backup Withholding Provisions*

Section 6041(a) requires persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of $600 or more in any one taxable year to file information returns with the IRS and to furnish information statements to payees. Among other items, the payor must include the payee's name and taxpayer identification number (TIN) on the information return and the information statement.

Section 1.6041–3 of the Income Tax Regulations provides that information returns are not required for certain payments. Section 1.6041–3(p)(1) provides that an information return is not required for payments made to a corporation. Section 1.6041–3(c) provides that an information return is not required for payments of bills for merchandise, telegrams, telephone, freight, storage, and similar charges.

Section 6109(a)(1) provides that a person required to make a return must include that person's identifying number in the return. Section 6109(a)(2) provides that a person (the payee) with respect to whom a return is required to be made by another person (the payor) or whose identifying number is required to be shown on a return of another person must furnish to the other person the identifying number prescribed for securing the proper identification of the payee. Section 6109(a)(3) provides that a person (the payor) required to make a return with respect to another person (the payee) must ask the other person for the identifying number prescribed for securing the proper identification of the payee and include that number in the return.

In general, section 6721(a)(1) imposes a $50 penalty for each failure to file an information return on or before the required filing date, for any failure to include all of the information required to be shown on the return, or for the inclusion of incorrect information.

Section 6724(a) provides that no penalty will be imposed under section 6721 if it is shown that the failure is due to reasonable cause and not to willful neglect.

Section 3406(a)(1) requires a payor to withhold on any reportable payment (as defined in section 3406(b)(1)) in certain situations, including if (1) the payee fails to furnish his TIN to the payor as required or (2) the Secretary notifies the payor that the TIN furnished by the payee is incorrect.

Section 3406(i) provides that the Secretary shall prescribe the regulations necessary or appropriate to carry out the purposes of section 3406.

3. *TIN Matching*

Regulations issued under section 3406(i) (§ 31.3406(j)–1 of the Employment Tax Regulations) provide that the Commissioner has the authority to establish TIN matching programs through revenue procedures or other appropriate guidance. Under the regulations, a payor participating in a TIN matching program may contact the IRS with respect to the TIN furnished by a payee before filing information returns for reportable payments. The regulations further provide that the IRS will inform the payor whether or not the name/TIN combination furnished by the payee matches a name/TIN combination maintained for the TIN matching program.

Pursuant to the authority in § 31.3406 (j)–1, the IRS issued Rev. Proc. 97–31, 1997–1 C.B. 703, and implemented TIN matching for reportable payments by Federal agency payors. The IRS is issuing a second TIN matching revenue procedure to expand the scope of the TIN Matching Program by allowing all payors (and not merely Federal agency payors) to participate in TIN matching for reportable payments. Under the authority of the temporary regulations discussed above, payors' authorized agents will also be permitted to participate in TIN matching.

4. *Payment Card Transactions*

A *payment card transaction* is a transaction in which a cardholder/payor uses a payment card to purchase goods or services and a merchant agrees to accept a payment card as a means of obtaining payment. A *payment card* is a card (or an account) issued by a payment card organization, or one of its members or affiliates, to a cardholder/payor which, upon presentation to a merchant/payee, represents an agreement of the cardholder to pay the merchant through the payment card organization. A *payment card organization* is an entity that sets the standards and provides the mechanism, either directly or indirectly through members and affiliates, for effectuating payment between a purchaser and a merchant in a payment card transaction. A payment card organization generally provides this mechanism by issuing payment cards, enrolling merchants as authorized acceptors of payment cards for payment for goods or services, and ensuring the system conducts the transactions in accordance with prescribed standards of payment card transactions.

The parties involved in payment card transactions may include the cardholder/payor, the merchant/payee, a bank that issues a payment card (issuing bank), a merchant/payee's bank (merchant bank, acquiring bank, or acquirer), and the payment card organization.

Cash does not pass directly from the cardholder/payor to the merchant/payee for purchases made with a payment card. Rather, in some situations, payment is made by a credit from the issuing bank, through the payment card organization, to the merchant's bank account. In turn, the cardholder pays the issuing bank upon receipt of the payment card monthly billing statement. In other situations, payment is made directly from the payment card organization to the merchant. In turn, the cardholder pays the payment card organization upon receipt of the payment card monthly billing statement.

5. *Information Reporting and Backup Withholding Difficulties for Payment Card Transactions*

Information reporting compliance is difficult in payment card transactions because an invoice may not be issued, and the employee of the cardholder/payor may not request and obtain the name/TIN combination of the merchant/payee at the time of the transaction. In addition, backup withholding may be difficult because a merchant receives payment from the payment card organization within a few days after the transaction, but the cardholder does not pay the payment card organization until after it receives a payment card monthly billing statement from the payment card organization.

Because of these difficulties, representatives of the payment card industry and the Information Reporting Program Advisory Committee (IRPAC) have proposed that the IRS allow a payment card organization to act on behalf of a cardholder/payor for purposes of soliciting, collecting, and validating the names/TINs of the merchant/payees through TIN matching. In addition, they suggest that the payment card organization be allowed to inform the cardholder about a merchant's corporate status.

The IRS is issuing a proposed revenue procedure that would allow a payment card organization to obtain an IRS determination that it is a *Qualified Payment Card Agent* (QPCA). The proposed procedure would permit a QPCA to act on behalf of a payor for purposes of soliciting, collecting, and validating merchants' names/TINs, and providing merchants' corporate status. To obtain a QPCA determination, the payment card organization would be required, among other things, to demonstrate the reliability of its data by participating in the IRS TIN Matching Program and matching its merchant name/TIN data with IRS name/TIN data.

Certain payment card industry representatives have suggested that, for payments made through a QPCA, the information provided to the cardholder/payor should be sufficiently reliable that backup withholding should not apply. In addition, they have suggested that a cardholder/payor who files incorrect information returns should be considered to meet the reasonable cause requirements for a waiver under section 6724 if the cardholder/payor relied on payee information provided by a QPCA.

The IRS and the Treasury Department agree that QPCAs, by obtaining TINs and participating in the IRS TIN Matching Program, can enhance the accuracy of information reporting by the cardholder/payors. Accordingly, the IRS and the Treasury Department agree that a limited exception to the backup withholding requirements is appropriate if cardholder/payors rely on a QPCA to solicit, collect, and validate merchant/payees' TINs. In addition, the IRS and the Treasury Department agree that cardholder/payors may establish reasonable cause based on reliance on merchant/payees' TINs supplied through a QPCA.

Explanation of Provisions

1. *Backup Withholding*

The proposed regulations provide that backup withholding does not apply to payment card transactions if the reportable payments are made through a QPCA and the payee is a qualified payee. The proposed regulations provide that a payee is qualified if, at the time of the payment, the QPCA has validated the payee's TIN through the IRS TIN Matching Program or if the payment is made during the 6-month period following the date on which the QPCA first obtained the payee's TIN.

The proposed regulations provide that reportable payments made through a QPCA are also exempt from backup withholding if the payment is made within 60 days after the date of the first payment with respect to which the QPCA is required to provide notification to the payor that the payee is not a qualified payee. Under the proposed regulations, a QPCA must notify a cardholder/payor of any merchant/payees that are not qualified payees. The notice must appear on the billing information for the payment. The regulations clarify that this notification does not constitute notice by the IRS that the payee's TIN is incorrect for purposes of backup withholding.

2. *Waiver Under Section 6724 for Reasonable Cause*

The proposed regulations provide that a cardholder/payor may establish reasonable cause based on its reliance on a QPCA. Under the proposed regulations, special solicitation rules will apply if the cardholder/payor relies on a QPCA. Under those rules, a cardholder/payor is not required to make the initial solicitation of a payee's TIN at the time of the transaction and generally is not required to undertake the first and second annual solicitations. Under the proposed regulations, a cardholder/payor that relies on a QPCA is required to solicit a payee's TIN only if the QPCA fails to provide, within a specified period, a TIN that the cardholder/payor believes in good faith to be the payee's correct TIN.

3. *Effective Dates*

Section 31.3406(j)–1(a) and (f) are applicable January 31, 2003. The amendments of § 31.3406(g)–1 are proposed to be applicable for payments on or after January 1, 2004. The amendments of § 301.6724–1 are proposed to be applicable for information returns required to be filed, and information statements required to be furnished, after December 31, 2004. The amendments to §§ 31.3406(g)–1 and 301.6724–1 will not be applicable until they are finalized.

Special Analyses

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

It is hereby certified pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6) that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. The reporting burden affects financial institution members of the payment card network that are affiliates of QPCAs. Most of these financial institution members are large businesses. To the extent that small financial institutions have a reporting burden, the burden is expected to be insignificant. Accordingly, a Regulatory Flexibility Analysis is not required.

Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for May 21, 2003, beginning at 10 a.m. in room 6718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be permitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 30, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 31 and 301 are proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT THE SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Par. 2. Section 31.3406(g)–1 is amended by adding paragraph (f) to read as follows:

§ 31.3406(g)–1 Exceptions for payments to certain payees and certain other payments.

* * * * *

(f) *Special rule for certain payment card transactions*—(1) *In general*. No withholding under section 3406 is required for a reportable payment made through a payment card organization if the payment is made on or after January 1, 2004, the organization is a Qualified Payment Card Agent (QPCA), and—

(i) The payee is a qualified payee (as defined in paragraph (f)(2)(v) of this section) with respect to the payment; or

(ii) The payment is made during the 60-day period following the date on which the payor made the first payment with respect to which the QPCA is required under paragraph (f)(3) of this section to provide notification that the payee is not a qualified payee.

(2) *Definitions*—(i) *Payment card defined.* For purposes of this section, a *payment card* is a card (or an account) issued by a payment card organization, or one of its members or affiliates, to a cardholder/payor which, upon presentation to a merchant/payee, represents an agreement of the cardholder to pay the merchant through the payment card organization.

(ii) *Payment card organization defined.* For purposes of this section, a *payment card organization* is an entity that sets the standards and provides the mechanism, either directly or indirectly through members and affiliates, for effectuating payment between a purchaser and a merchant in a payment card transaction. A payment card organization generally provides such a payment mechanism by issuing payment cards, enrolling merchants as authorized acceptors of payment cards for payment for goods or services, and ensuring the system conducts the transactions in accordance with prescribed standards for payment card transactions.

(iii) *Payment card transaction defined.* For purposes of this section, a *payment card transaction* is a transaction in which a cardholder/payor uses a payment card to purchase goods or services and a merchant agrees to accept a payment card as a means of obtaining payment.

(iv) *Qualified Payment Card Agent (QPCA) defined.* For purposes of this section, a *Qualified Payment Card Agent* (QPCA) is a payment card organization that has a current QPCA determination from the Internal Revenue Service (IRS) under applicable procedures (see § 601.601(d)(2) of this chapter).

(v) *Qualified payee defined.* For purposes of this section, a payee is a *qualified payee* with respect to a reportable payment if—

(A) At the time of the payment, the QPCA has obtained the payee's TIN and the payee's TIN has been validated through the IRS TIN Matching Program; or

(B) The payment is made during the 6-month period following the date on which the QPCA first obtained the payee's TIN.

(3) *Notification of payee status.* In the case of a reportable payment to a payee other than a qualified payee (as defined in paragraph (f)(2)(v) of this section) with respect to the payment, the QPCA must notify the payor on the billing information for the payment that the payee is not a qualified payee. The notification must appear on the face of the bill in print size no smaller than the print size used for the charge amount relating to the purchase from the payee. Notification may consist of an asterisk, footnote, or other mark next to the payee's name or the charge, with the text of the notification at the bottom of the page or at the end of the list of charges. Notification by the QPCA that a payee is not a qualified payee does not constitute notice by the IRS that the payee's TIN is incorrect for purposes of section 3406(a)(1)(B) and § 31.3406(d)–5.

Par. 3. In § 31.3406(j)–1, paragraphs (a) and (f) are revised to read as follows:

§ 31.3406(j)–1 Taxpayer Identification Number (TIN) matching program.

(a) [Section 31.3406(j)–1(a) is the same as § 31.3406(j)–1T(a) published elsewhere in this issue of the **Federal Register**.]

* * * * *

(f) [Section 31.3406(j)–1(f) is the same as § 31.3406(j)–1T(f) published elsewhere in this issue of the **Federal Register**.]

PART 301—PROCEDURE AND ADMINISTRATION

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

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

Par. 5. Section 301.6724–1 is amended by:

1. Revising the introductory language of paragraph (c)(6).

2. Adding paragraphs (e)(1)(vi)(H) and (f)(5)(vii).

The revision and additions read as follows:

§ 301.6724–1 Reasonable cause.

* * * * *

(c)* * *

(6) *Actions of the payee or any other person.* In order to establish reasonable cause under paragraph (c)(1) of this section due to the actions of the payee or any other person, such as a broker as defined in section 6045(c) or a Qualified Payment Card Agent (QPCA) as defined in § 31.3406(g)–1(f)(2)(iv) of this chapter, pro-

viding information with respect to the return or payee statement, the filer must show either—

* * * * *

(e) * * * (1) * * *

(vi) * * *

(H) In the case of information returns required to be filed, and information statements required to be furnished, after December 31, 2004, the filer—

(*1*) Satisfies the solicitation requirements of paragraphs (e)(1)(i) and (ii) of this section with respect to a payment made through a QPCA if the filer relies in good faith on the QPCA to solicit, record, validate, and furnish the payee's TIN; and

(*2*) Satisfies the solicitation requirement of paragraph (e)(1)(iii) of this section with respect to such a payment if, on or before December 31 of the year immediately succeeding the calendar year in which the payment is made, the filer undertakes a solicitation of the payee's TIN or receives from the QPCA a TIN that the filer believes in good faith to be the payee's correct TIN.

* * * * *

(f) * * *

(5) * * *

(vii) In the case of information returns required to be filed, and information statements required to be furnished, after December 31, 2004, the filer—

(A) Satisfies the solicitation requirement of paragraph (f)(1)(i) of this section with respect to a payment made through a QPCA if the filer relies in good faith on the QPCA to solicit, record, validate, and furnish the payee's TIN; and

(B) Satisfies the solicitation requirement of paragraph (f)(1)(ii) or (iii) of this section, whichever is applicable, with respect to such a payment if, after the date the filer is notified that the account of the payee contains an incorrect TIN and on or before the date by which the applicable requirement must be satisfied, the filer solicits the payee's correct TIN in a manner that satisfies the applicable requirement or receives from the QPCA a TIN that the filer believes in good faith to be the payee's correct TIN.

* * * * *

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 30, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 31, 2003, 68 F.R. 4970)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence

REG–138882–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9031) relating to the reduced maximum exclusion available to certain taxpayers who sell or exchange their principal residence but who have not owned and used the property as their principal residence for two years of the preceding five years or who have excluded gain on a previous sale or exchange within the last two years. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by March 24, 2003.

ADDRESSES: Send submissions to CC:ITA:RU (REG–138882–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:ITA:RU (REG–138882–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Sara Paige Shepherd, (202) 622–4960; concerning submissions of comments and/or requests for a hearing, LaNita Van Dyke, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations (T.D. 9031) in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) under section 121(c) of the Internal Revenue Code (Code). The temporary regulations provide rules for a reduced maximum exclusion of gain from the sale or exchange of the principal residence of a taxpayer who is not entitled to the full maximum exclusion under section 121(a) because the taxpayer has not owned and used the property as the taxpayer's principal residence for two years of the preceding five years or has excluded gain under section 121 on a previous sale or exchange within the last two years. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the regulations do not impose a collection of information and apply only to individuals. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7508(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.121–3, paragraphs (b) through (f), (h), (k), and (l) are revised to read as follows:

§ 1.121–3 Reduced maximum exclusion for taxpayers failing to meet certain requirements.

[The text of proposed paragraphs (b) through (f), (h), (k), and (l) of § 1.121–3 is the same as the text of paragraphs (b) through (f), (h), (k), and (l) of § 1.121–3T published elsewhere in this issue of the **Federal Register**.]

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 23, 2002, and published in the issue of the Federal Register for December 24, 2002, 67 F.R. 78398)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

Bulletins 2003–1 through 2003–7

Announcements:

2003–1, 2003–2 I.R.B. *281*
2003–2, 2003–3 I.R.B. *301*
2003–3, 2003–4 I.R.B. *361*
2003–4, 2003–5 I.R.B. *396*
2003–5, 2003–5 I.R.B. *397*
2003–6, 2003–6 I.R.B. *450*
2003–7, 2003–6 I.R.B. *450*
2003–8, 2003–6 I.R.B. *451*
2003–9, 2003–7 I.R.B. *490*
2003–10, 2003–7 I.R.B. *490*

Notices:

2003–1, 2003–2 I.R.B. *257*
2003–2, 2003–2 I.R.B. *257*
2003–3, 2003–2 I.R.B. *258*
2003–4, 2003–3 I.R.B. *294*
2003–5, 2003–3 I.R.B. *294*
2003–6, 2003–3 I.R.B. *298*
2003–7, 2003–4 I.R.B. *310*
2003–8, 2003–4 I.R.B. *310*
2003–9, 2003–5 I.R.B. *369*
2003–10, 2003–5 I.R.B. *369*
2003–11, 2003–6 I.R.B. *422*
2003–12, 2003–6 I.R.B. *422*

Proposed Regulations:

REG–209500–86, 2003–2 I.R.B. *262*
REG–125638–01, 2003–5 I.R.B. *373*
REG–126016–01, 2003–7 I.R.B. *486*
REG–124069–02, 2003–7 I.R.B. *488*
REG–151043–02, 2003–3 I.R.B. *300*
REG–164464–02, 2003–2 I.R.B. *262*

Revenue Procedures:

2003–1, 2003–1, I.R.B. *1*
2003–2, 2003–1, I.R.B. *76*
2003–3, 2003–1, I.R.B. *113*
2003–4, 2003–1, I.R.B. *123*
2003–5, 2003–1, I.R.B. *163*
2003–6, 2003–1, I.R.B. *191*
2003–7, 2003–1, I.R.B. *233*
2003–8, 2003–1, I.R.B. *236*
2003–10, 2003–2 I.R.B. *259*
2003–11, 2003–4 I.R.B. *311*
2003–12, 2003–4 I.R.B. *316*
2003–13, 2003–4 I.R.B. *317*
2003–14, 2003–4 I.R.B. *319*
2003–15, 2003–4 I.R.B. *321*
2003–16, 2003–4 I.R.B. *359*
2003–17, 2003–6 I.R.B. *427*
2003–18, 2003–6 I.R.B. *439*
2003–19, 2003–5 I.R.B. *371*
2003–20, 2003–6 I.R.B. *445*
2003–21, 2003–6 I.R.B. *448*

Revenue Rulings:

2003–1, 2003–3 I.R.B. *291*
2003–2, 2003–2 I.R.B. *251*
2003–3, 2003–3 I.R.B. *252*

Revenue Rulings—Continued:

2003–4, 2003–4 I.R.B. *253*
2003–5, 2003–5 I.R.B. *254*
2003–6, 2003–3 I.R.B. *286*
2003–7, 2003–5 I.R.B. *363*
2003–8, 2003–3 I.R.B. *290*
2003–9, 2003–4 I.R.B. *303*
2003–10, 2003–3 I.R.B. *288*
2003–11, 2003–3 I.R.B. *285*
2003–12, 2003–3 I.R.B. *283*
2003–13, 2003–4 I.R.B. *305*
2003–14, 2003–4 I.R.B. *302*
2003–15, 2003–4 I.R.B. *302*
2003–16, 2003–6 I.R.B. *401*
2003–17, 2003–6 I.R.B. *400*
2003–18, 2003–7 I.R.B. *467*
2003–19, 2003–7 I.R.B. *468*
2003–20, 2003–7 I.R.B. *465*

Treasury Decisions:

9024, 2003–5 I.R.B. *365*
9025, 2003–5 I.R.B. *362*
9026, 2003–5 I.R.B. *366*
9027, 2003–6 I.R.B. *413*
9028, 2003–6 I.R.B. *415*
9029, 2003–6 I.R.B. *403*
9032, 2003–7 I.R.B. *471*
9033, 2003–7 I.R.B. *483*
9034, 2003–7 I.R.B. *453*

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2002–26 through 2002–52 is in Internal Revenue Bulletin 2003–1, dated January 6, 2003.

Finding List of Current Actions on Previously Published Items[2]

Bulletins 2003–1 through 2003–7

Notices:

97–19
Modified by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

2001–26
Obsoleted by
T.D. 9032, 2003–7 I.R.B. *471*

2001–46
Modified by
Notice 2003–6, 2003–3 I.R.B. *298*

2001–69
Modified and superseded by
Notice 2003–1, 2003–2 I.R.B. *257*

2002–27
Clarified by
Notice 2003–3, 2003–2 I.R.B. *258*

2002–46
Modified by
Notice 2003–10, 2003–5 I.R.B. *369*

Proposed Regulations:

REG–209500–86
Corrected by
Ann. 2003–6, 2003–6 I.R.B. *450*

REG–164464–02
Corrected by
Ann. 2003–6, 2003–6 I.R.B. *450*

Revenue Procedures:

83–23
Supplemented by
Rev. Proc. 2003–21, 2003–6 I.R.B. *448*

84–37
Modified by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

93–38
Obsoleted by
Rev. Proc. 2003–15, 2003–4 I.R.B. *321*

98–13
Obsoleted by
T.D. 9032, 2003–7 I.R.B. *471*

2002–1
Superseded by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

2002–2
Superseded by
Rev. Proc. 2003–2, 2003–1 I.R.B. *76*

2002–3
Superseded by
Rev. Proc. 2003–3, 2003–1 I.R.B. *113*

Revenue Procedures—Continued:

2002–4
Superseded by
Rev. Proc. 2003–4, 2003–1 I.R.B. *123*

2002–5
Superseded by
Rev. Proc. 2003–5, 2003–1 I.R.B. *163*

2002–6
Superseded by
Rev. Proc. 2003–6, 2003–1 I.R.B. *191*

2002–7
Superseded by
Rev. Proc. 2003–7, 2003–1 I.R.B. *233*

2002–8
Superseded by
Rev. Proc. 2003–8, 2003–1 I.R.B. *236*

2002–9
Modified and amplified by
Rev. Proc. 2003–20, 2003–6 I.R.B. *445*
Rev. Rul. 2003–3, 2003–2 I.R.B. *252*

2002–22
Modified by
Rev. Proc. 2003–3, 2003–1 I.R.B. *113*

2002–29
Modified by
Rev. Proc. 2003–10, 2003–2 I.R.B. *259*

2002–52
Modified by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

2002–67
Supplemented by
Ann. 2003–3, 2003–4 I.R.B. *361*

2002–75
Superseded by
Rev. Proc. 2003–3, 2003–1 I.R.B. *113*

2003–3
Amplified by
Rev. Proc. 2003–14, 2003–4 I.R.B. *319*

2003–7
Corrected by
Ann. 2003–4, 2003–5 I.R.B *396*

Revenue Rulings:

53–131
Modified by
Rev. Rul. 2003–12, 2003–3 I.R.B. *283*

57–190
Obsoleted by
Rev. Rul. 2003–18, 2003–7 I.R.B. *467*

65–190
Revoked by
Rev. Rul. 2003–3, 2003–2 I.R.B. *252*

69–372
Revoked by
Rev. Rul. 2003–3, 2003–2 I.R.B. *252*

Treasury Decisions:

9002
Corrected by
Ann. 2003–8, 2003–6 I.R.B. *451*

9022
Supplemented by
Ann. 2003–7, 2003–6 I.R.B. *450*

[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–26 through 2002–52 is in Internal Revenue Bulletin 2003–1, dated January 6, 2003.

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