calendar years. The final rule provides that dividends reinvested within one year of receipt do not reduce the additional investment that may be made under general consent. The final rule also provides that any investment in an organization, pursuant to section 211.5(c), will reduce the additional amount that an investor may invest in that organization in any year under general consent.

Finally, the Board adopted, substantially as proposed, a provision defining "historical cost", and a provision limiting additional investments that may be made under general consent procedures to 10 per cent of the investor's capital and surplus. An investment exceeding this limit would have to be made under specific consent procedures.

This action is taken pursuant to the Board's authority under sections 25 and 25(a) of the Federal Reserve Act (12 U.S.C. 601, 615) and section 4(c)(13) of the Bank Holding Company Act (12 U.S.C. 1843(c)(13)).

Effective November 12, 1980, Part 211 of 12 CFR Chapter II is amended as follows:

By revising § 211.5(c)(1)(ii) and redesignating paragraph (c)(1)(iii) as (c)(1)(iv) and adding a new paragraph (c)(1)(iii) as follows:

§ 211.5 Investments in other organizations.

* * * * *

(c) *Investment Procedures.*

* * * * *

(1) *General consent.* The Board grants its general consent for the following:

* * * * *

(ii) Any additional investment in an organization in any calendar year so long as (A) the investment does not cause the organization to be a direct or indirect subsidiary or joint venture of the investor; (B) the total amount invested in that calendar year does not exceed 10 per cent of investor's capital and surplus; and, (C) the total amount invested under Part 211 in the current calendar year does not exceed cash dividends reinvested pursuant to paragraph (iii) below plus the greater of (*1*) 10 per cent of the investor's direct and indirect historical cost [6] in such organization, or (*2*) 50 per cent of the investor's direct and indirect historical cost in that organization less any amounts invested in that organization during the previous four calendar years (excluding dividends reinvested pursuant to paragraph (iii) below); or

(iii) Any additional investment in an organization in an amount equal to cash dividends received from that organization during the preceding 12 calendar months so long as such investment does not cause the organization to be a direct or indirect subsidiary or joint venture of the investor; or

(iv) * * *

By Order of the Board of Governors, effective November 12, 1980.

Theodore E. Allison,

Secretary of the Board.

[FR Doc. 80-35942 File 11-17-80; 8:45 am]

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[6] The "historical cost" of an investment consists of the actual amounts paid for shares or otherwise contributed to the capital accounts, as measured in dollars at the exchange rate in effect at the time each investment was made. It does not include subordinated debt or unpaid commitments to invest even though these may be considered investments for other purposes of this Part. For investments acquired indirectly as a result of acquiring a subsidiary, the historical cost to the investor is measured as of the date of acquisition of the subsidiary; at the net asset value of the equity interest in the case of subsidiaries and joint ventures, and in the case of portfolio investments, at the book carrying value.

FEDERAL HOME LOAN BANK BOARD

12 CFR Parts 525, 541, 545, and 563

[No. 80-700]

Revision of Real Estate Lending Regulations

Dated: November 10, 1980.

AGENCY: Federal Home Loan Bank Board.

ACTION: Final regulations.

SUMMARY: These final regulations implement in part Title IV of the Depository Institutions Deregulation and Monetary Control Act of 1980, which comprehensively revised and expanded the real estate lending authority of Federal savings and loan associations. Major changes include the lifting of restrictions on location of security property, lien priority and dollar amount of loans.

EFFECTIVE DATE: November 17, 1980.

FOR FURTHER INFORMATION CONTACT: Nancy L. Feldman, Associate General Counsel, (202) 377-6440, Federal Home Loan Bank Board, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION: The Depository Institutions Deregulation and Monetary Control Act of 1980 ("Act"), Pub. L. 96-221, 94 Stat. 132, greatly expanded the investment powers of Federal savings and loan associations; an important part of this expansion is set forth in section 401 of Title IV of the Act, which revised section 5(c) of the Home Owners Loan Act of 1933 (12 U.S.C. 1464(c)) with regard to the real-estate-related lending authority of Federals.

On July 31, 1980, the Federal Home Loan Bank Board proposed to implement the statutory amendments through comprehensive changes to its lending regulations. Since a major purpose of expanding Federal associations' lending authority was to make them more competitive with other financial institutions, the Board proposed not only to remove restrictions no longer mandated by statute, but also to rescind some of its current rules which set forth detailed lending procedures the Board believed should more properly be determined by an association's management. The Board also proposed to regroup its lending regulations to better reflect the proposed changes, and to delete provisions in other parts of its regulations which would be inconsistent with such changes.

The Board received 100 comment letters from Federal and state-chartered savings and loan associations and other mortgage lenders, trade groups, mortgage insurers, consumers and others. Respondents were overwhelmingly in favor of the proposed lifting of regulatory restrictions, although many suggested modification of specific provisions. In response to comments received and other pertinent information available, the Board has determined to adopt the regulatory amendments substantially as proposed, with modifications described below.

Definition of Real Estate Loans

The Act eliminated the first-lien security requirements previously applied to Federal associations' basic residential lending authority, thus allowing investment in real estate loans on the security of junior liens. In order to differentiate real estate loans where appraisals and other loan-closing services are appropriate from real-estate-secured consumer loans and home-improvement loans based primarily on the creditworthiness of the borrower, 12 CFR 545.6 ("Real estate loans") has been amended to characterize a real estate loan as any loan secured by real estate where the association relies substantially on that real estate as the primary security for the loan. The Board expects that loans to finance the purchase of real estate, where that real estate secures the loan, ordinarily will be characterized as real estate loans.

Determination of Loan-To-Value Ratios for Junior Liens

The Board's proposal required that associations making loans on the security of junior liens prepare and maintain documentation sufficient to indicate that the total liens on the property do not exceed applicable loan-to-value ratios. Estimations of such ratios would reflect a current appraisal of the property at the time the association's loan is to be made and, if such loan is for improvement of the security property, could include an estimate of the expected value of the property after completion of such improvements.

Commenters suggested four exclusions from the computation of total prior liens: (1) unrecorded liens, (2) the paid portion of existing loans, (3) liens as to which the lienholder agrees to take a subrogated position to the association's lien, and (4) encumbrances that would be paid off out of the proceeds of the new loan. The Board believes that these suggestions are consistent with its requirement that the loan-to-value-ratio determination address only those encumbrances which would take precedence to the association's lien, and has amended the proposed provision accordingly.

In response to questions regarding the meaning of "value" in connection with appraised value of real estate, this term has been defined as market value.

Insured and Guaranteed Loans

Specific required percentages of FHA insurance and VA guarantee of loans have been deleted from 12 CFR 545.6–1, which authorizes investment in such loans, on the ground that they are unnecessary. The regulation now requires only that associations meet terms and conditions of repayment acceptable to the insuring or guaranteeing agency.

Loans to finance land development that are insured under Title X of the National Housing Act, which were treated separately under 12 CFR 545.6–7, are now included in § 545.6–1.

The Board's regulations provide that private mortgage insurance is not necessary for a low-downpayment loan that is insured or guaranteed by a state agency pledging its full faith and credit to support the insurance or guarantee. The Board's proposal offered an alternative to the full-faith-and-credit requirement by including in the authorization state insurance or guarantee programs approved by the Federal Home Loan Mortgage Corporation. The Board believes that this alternative will be helpful to consumers in states that have sound programs that insure or guarantee only a portion of each loan. Because the FHLMC does not currently have an approval process for public insurers, the Board has amended the proposed provision to include state programs approved by the Federal National Mortgage Corporation, which does have such a process.

Dollar Limits on Loans

The Act eliminated the previous statutory dollar restrictions on home loans ($75,000; $112,500 for loans secured by real estate in Alaska, Guam, and Hawaii) and dollar limitations referenced to section 207(c)(3) of the National Housing Act of 1934, as amended, for multifamily-dwelling loans; it also removed the 20-percent-of-assets exception for the portion of loans in excess of these amounts. The Board therefore has eliminated all dollar restrictions on loans, including low-downpayment loans and home-improvement loans, except with respect to its loans-to-one borrower limitation and affiliated-person loan limitations, found in Part 563 of the Regulations for the Federal Savings and Loan Insurance Corporation (12 CFR Part 563). With respect to the Board's loan-to-one-borrower regulation, the proposed increase in the minimum dollar amount for new institutions, from $100,000 to $200,000, has been modified to index the latter figure to cost-of-living adjustments.

As a related matter, the Board also has rescinded 12 CFR 525.13 of the Regulations of the Federal Home Loan Bank System, which limited the dollar amount of home mortgages eligible as collateral for Bank advances. That provision implemented section 10(b)(2) of the Federal Home Loan Bank Act of 1932, which refers to the now-rescinded dollar limitations on home loan amounts in section 5(c) of the Home Owners' Loan Act.

Home Loans (1-to-4-Family Dwellings)

1. Loan-to-value ratios

The previous section 5(c) did not contain statutory references to loan-to-value ratios for real estate loans; the statute as revised uses 90 percent of value as a reference point for residential real estate loans that will not require the extra security of mortgage insurance. The Board therefore has adopted as proposed a liberalization of its residential lending regulations recognizing 90-percent loans rather than 80-percent loans as the basic home finance benchmark, and limiting regulatory restrictions previously applied to home loans between 80 and 90 percent to those in excess of 90 percent, with one exception relating to loans for condominium and co-operative conversions. Because of general concerns expressed on this subject, the Board has determined at this time to retain the requirement, but apply it only to co-op and condominium conversion loans, that loans in excess of 80 percent of value may be made only to borrowers who intend to occupy the property as a principal residence.

2. Loans to facilitate trade-ins

The Board's proposal had provided that loans to facilitate a trade-in or exchange of property, which have a maximum 18-month term, be maintained at the 80 percent loan-to-value ratio, and that such loans be restricted to five percent of an association's assets. In adopting final regulations, the Board has determined to conform these loans to the 90-percent benchmark, and to remove the asset limitation as artificial and unnecessary. The proposal also contained parenthetical regulatory language referring to the inclusion in this provision of "bridge loans" to individuals and brokers, because current regulatory language did not appear to permit such loans. The provision as adopted, however, clearly authorizes all facilitating loans without restrictions regarding borrowers, and inclusion of the proposed parenthetical is unnecessary.

3. Maximum term

In recognition of recent rapid increases in housing costs, and as an expression of its desire to assist potential borrowers in meeting associations' eligibility requirements regarding loan repayments, the Board proposed to allow associations to make home loans with maximum terms of 40 years. A number of commenters opposed this liberalization, arguing that the decrease in monthly payments would be slight while the total increase in interest payments over a 40-year term would be substantial. The Board recognizes these concerns but believes that a maximum 40-year term should be authorized for those borrowers, especially first-time homebuyers, who would be helped by even a modest decrease in their monthly costs, and notes that average mortgage maturity statistics indicate that few mortgages would be held for a 40-year term. Having determined at this time to authorize the 40-year maximum term, however, the Board intends to ascertain the frequency of its use, and encourages associations offering 40-year mortgages to disclose to borrowers the financial consequences inherent in the longer amortization schedule.

4. Private mortgage insurance requirement

The Board's regulations have long required that loans in excess of 90 percent of the value of the security property have private mortgage insurance ("PMI") coverage down to 80 percent of value until the loan principal is reduced to 90 percent, at which time the PMI coverage is no longer mandatory. This provision was adopted on the grounds that loans in excess of 90 percent of value are statistically riskier investments for associations and require additional protection during their early years.

The proposal would have reduced the required depth of PMI coverage to the statutory minimum, i.e. the amount of loan principal in excess of 90 percent of value. A number of commenters urged the Board to retain the current rule, citing increased risks related to higher dollar loans, longer terms and adjustable interest rates, as well as the negative impact of inflation on the borrower's ability to carry mortgage payments and other housing-related costs. Upon reconsideration, the Board has determined at present not to reduce its current PMI requirements.

5. Pledged-account loans

The Board's regulations authorize home loans made in excess of maximum loan-to-value ratios where the excess loan amount is secured by pledged savings accounts. With regard to loans in excess of 80 percent of value, certain restrictions apply. The Board has determined to conform this provision with its new home-loan benchmark by applying the restrictions only to loans in excess of 90 percent, and to exclude amounts covered by the pledged account from calculation of the loan amount required to be covered by mortgage insurance. In addition, the Board notes the confusion that has arisen in the past few years regarding a provision in this section requiring these loans to comply with the Board's graduated-payment-mortgage regulations, and has deleted that requirement.

In response to inquiry by commenters, the Board notes that the savings account is not required to be on deposit with the lender association, so long as it is pledged to the association.

6. Nonamortized loans

The proposal provided for a liberalization of the maximum loan term on nonamortized home loans from three to five years; the maximum loan-to-value ratio remained unchanged at 60 percent. Some commenters recommended to the Board that 80% nonamortized loans be authorized. A few commenters also suggested that the Board allow partially-amortized home loans with long terms; present regulations limit these to multifamily-dwelling and commercial loans.

The Board recognizes that such balloon-payment loans with lower initial monthly payments could serve as a vehicle to qualify more potential homebuyers. The Board is concerned, however, with the risk possibilities for home borrowers and associations in the event that refinancing is unavailable at the time the loan becomes due; that is why the Board has included guaranteed refinancing and other consumer and lender protections in its authorized mortgage plans that provide for fluctuating payments. The Board will continue to carefully study this area, but has determined at the present time not to authorize nonamortized or partially-amortized balloon-payment home loans as a permanent-financing option.

The Board has determined, however, to liberalize its current regulations pertaining to flexible-payment loans, which authorize an initial period of interest-only payments and full amortization over the remaining mortgage term. The flexible-payment loan, which is authorized to be made to borrowers intending to occupy the security property, may now be made on one-to-four-family dwellings rather than single-family dwellings only, and may use the Board's adjustable rate mortgage plans (12 CFR 545.6–4 and 545.6–4a). In addition, the five-percent-of-assets limitation has been removed.

Multifamily Dwelling Loans

The Board has adopted as proposed a 90-percent loan-to-value ratio for these loans, which have 30-year maximum terms. The maximum loan-to-value ratio on nonamortized loans has been raised from 60 percent to 75 percent, in conformance with national bank limitations, and the maximum term on nonamortized loans has been increased from three to five years. Two provisions in the current regulations that were not specifically mentioned in the proposed amendment, relating to semi-annual interest payments and partially-amortized loans, have been re-instated.

It is noted that 12 CFR 545.6–10 ("Housing facilities for the aging") has been deleted from the Board's regulations, as it is no longer needed to confer high-ratio lending authority for this type of multifamily housing. The definition of "other dwelling unit" has therefore been expanded to include nursing homes and convalescent homes.

Other Improved Real Estate—Residential

The revisions to the Board's acquisition, development, building lot and site, and construction loan regulations have been adopted substantially as proposed. Many commenters argued against the new, more restrictive loan-to-value ratios established for these investments; as noted in the preamble to the proposal, the restrictions are statutory.

Several commenters disapproved of continuation of a separate loans-to-one-borrower limitation for these loans that is more restrictive than the Board's general rule set out at 12 CFR 563.9–3 of the Insurance Regulations. The Board has determined to retain the separate limitation for development loans based on the relative risk of this type of lending, including the possibility that an association would have to expend additional funds to prepare a foreclosed development property for resale.

The proposal liberalized associations' authority to make building lot and site loans to borrowers who intend to use the property in the future as a principal dwelling. As proposed, the Board has expanded the maximum loan term from five to 15 years. In response to a number of comments, the Board also recognized that the current 40-percent amortization requirement is quite onerous to home borrowers during periods of high interest rates, and has therefore reduced this requirement to 30 percent.

A number of commenters urged the Board to lengthen the term of construction loans, both on projects and individual single-family-dwelling structures. The Board notes that the maximum three-year project construction loan term may be extended up to three additional years; the Board has determined, however, to allow a six-month extension of the 18-month maximum term on construction of individual single-family-dwelling structures.

Current provisions requiring semi-annual interest payments, that were not specifically mentioned in the proposed amendments, have been re-instated.

Rehabilitation Loans

Rehabilitation loans are made on the security of property that already contains an existing structure or structures. These loans are therefore not within the new statutory loan-to-value restrictions pertaining to loans on the security of property containing offsite improvements or in a construction phase. The Board's regulations accordingly allow these loans to be made under the loan-to-value ratios set out in § 545.6–2 (a) and (b). Under the first provision of the "combination loan" paragraph, rehabilitation loans may be combined with permanent financing loans.

Combination Loans

The Board has adopted, substantially as proposed, the provisions for combination of various types of interim and permanent financing loans.

Some commenters requested that the Board liberalize or remove the proposed amortization requirements for combination loans pertaining to different stages of development and construction; the Board has clarified the language of this provision to provide that the required repayments start three years after the initial disbursement of construction loan proceeds, and notes that the amortization schedule, while slightly more rapid than the current schedule, begins after three years rather than at the end of 18 months as has been required.

A new provision has been added to this regulation, which limits combination loans for construction inclusive of acquisition and/or development to a term of eight years with a three-year extension; the current maximum is a six-year term with two one-year extensions. The Board believes that the new limitation provides a very adequate time period for borrowers to complete projects.

Home Improvement Loans

The Board has liberalized its home improvement loan provision as proposed, by eliminating geographic restrictions, dollar limits, and percentage-of-assets investment limitations. In addition, the Board has provided for interest-rate and payment-adjustment authority for loans in compliance with 12 CFR 545.6–4 and 545.6–4a.

Leeway Authority

The provisions for unsecured construction loans and nonconforming secured loans have been amended to more closely follow the statutory authority. As noted in the preamble to the proposal, these provisions may be used by associations to invest in adjustable-rate mortgages not otherwise authorized under the Board's regulations. The term "residential real property," used only in the construction-loan leeway authority and proposed as a new definition section, proved confusing to commenters and has been deleted in favor of the term "residential real estate."

Commercial Real Estate Loans

The Board has adopted as proposed a 90-percent loan-to-value ratio and 30-year maximum term for commercial loans, and has, in addition, raised the loan-to-value ratio from 60 percent to 75 percent for nonamortized loans, in conformance with national bank lending authority. References to the inclusion in this section of construction loan and partially-amortized loan authority, which were not explicitly stated in the proposal, have been added.

The statute continues to require first-lien status for loan security under this section. The Board has therefore included a paragraph containing the first-lien definition formerly found in Part 541.

Collateral Loans

The proposal provided that an association could make a collateral loan if it were authorized to invest in the underlying assigned loan(s). As drafted, the provision might have been interpreted to mean, for example, that an association could invest up to half of its assets in loans secured by property with regard to which it was statutorily limited to a five-percent-of-assets investment. The provision has therefore been clarified to provide that collateral loans may be made to the extent that the underlying loans could be made directly.

Location of Security Property

The revised statute does not restrict associations in their ability to invest in loans outside their local areas; the Board therefore has adopted as proposed the elimination of geographic limitations on real estate loans. In order to give parity to insured institutions in relation to the new rules for Federals, the Board additionally has lifted the current geographic limitations on location of security property in the Insurance Regulations.

Notwithstanding these changes, the Board will continue to evaluate associations' efforts under the Community Reinvestment Act in satisfying the continuing and affirmative obligation to help meet the credit needs of their local communities, including low- and moderate-income neighborhoods.

A number of commenters urged the Board to retain its local eligible servicer requirements for out-of-area loans. The Board, however, has determined at this time to delete servicer requirements because it believes that association managements will continue to secure sound servicing arrangements for their distant loans, and because the servicer regulations unnecessarily hamper those associations that wish to do their own servicing.

Mobile Home Loans

Although mobile home loans are not real-estate loans and thus were not within the scope of the proposal, several commenters took the opportunity to request liberalizations to this set of regulations. Because the Board desires to make the mobile-home lending structure more similar to that of other residentially-related loans, the Board has determined to amend its mobile home loan regulations in certain respects to reflect changes in its real-estate regulations. Specifically, geographic-area prohibitions and seller-servicer requirements have been eliminated and the loans may be made using adjustable-rate mortgage plans authorized under 12 CFR 545.6–4 or 545.6–4a.

Conforming and Corrective Amendments

A number of existing regulations were slightly modified to reflect the new lending authority, including amendments to § 545.6–10 ("Community development loans and investment") and § 545.6–1.3 ("Farmers Home Administration Rural Housing Program guaranteed loans"). In addition, this opportunity was taken to correct an inadvertent omission in § 545.6–9 ("Loans on low-rent housing") to facilitate turn-key projects by eliminating the appraisal requirement on projects to be purchased by a local public housing authority.

The Board finds that a 30-day delay of effective date pursuant to 12 CFR 508.14 and 5 U.S.C 553(d) is unnecessary, as the amendments implement statutory revisions and relieve current regulatory restrictions.

Accordingly, the Federal Home Loan Bank Board hereby amends Part 525, Subchapter B, Parts 541 and 545, Subchapter C and Parts 561 and 563, Subchapter D, Chapter V of Title 12, Code of Federal Regulations, as set forth below.

SUBCHAPTER B—FEDERAL HOME LOAN BANK SYSTEM

PART 525—ADVANCES

1. Delete § 525.13 as follows:

§ 525.13 Home Mortgages exceeding $75,000.

[Rescinded effective November 17, 1980.]

SUBCHAPTER C—FEDERAL SAVINGS AND LOAN SYSTEM

PART 541—DEFINITIONS

2. Amend Part 541 by amending §§ 541.12, 541.14(a), 541.16 by adding paragraph (c), and 541.17(a) and (b), deleting § 541.23, and adding new § 541.25, to read as follows:

§ 541.12 Improved real estate.

Any of the real estate defined in §§ 541.3, 541.4, 541.5, 541.11, 541.16, or 541.17(b).

§ 541.14 Loans secured by liens on real estate.

(a) Loans secured by an interest in real estate in fee or in a leasehold or subleasehold extending or renewable automatically at the option of the holder or the Federal association for 5 years after maturity of the loan, if, in the event of default, the real estate interest could be used to satisfy the obligation with the same priority as a mortgage or a deed of trust in the jurisdiction where the real estate is located; and

* * * * *

§ 541.16 Other dwelling unit.

Real estate which comprises:

* * * * *

(b) * * * or (c) A structure(s) or parts thereof, designed or used for a nursing home or convalescent home.

§ 541.17 Other improved real estate.

(a) Commercial real estate containing (1) a permanent structure(s) constituting at least 25 percent of its value, or (2) improvements which make it usable by a business or industrial enterprise.

(b) Real estate containing offsite or other improvements, completed according to governmental requirements and general practice in the community, sufficient to make the property ready for primarily residential construction, and real estate in the process of being improved by a building or buildings to be constructed or in the process of construction for primarily residential use.

* * * * *

§ 541.23 Two-, three- or four-family dwelling.

[Rescinded effective November 17, 1980.]

§ 541.25 Unimproved real estate.

Real estate which will become improved real estate as defined in § 541.12 of this Part.

PART 545—OPERATIONS

3. Revise §§ 545.6, 545.6–1, and 545.6–2, by substituting new texts to read as follows:

§ 545.6 Real estate loans.

(a) *General.* A real estate loan is any loan secured by real estate where the association relies substantially upon that real estate as the primary security for the loan. A Federal association may invest in, sell, purchase, participate or otherwise deal in real estate loans or interests therein, only as provided in this Part.

(b) *Determination of loan-to-value ratios.*

(1) In determining compliance with maximum loan-to-value limitations in this Part, at the time of making a loan an association shall add together the unpaid amount of all recorded loans secured by prior mortgages, liens or other encumbrances on the security property that would take precedence over the association's loan, and shall not make such a loan unless the total amount of such loans (including the one to be made but excluding loans that will be paid off out of the proceeds of the new loan) does not exceed applicable maximum loan-to-value limitations prescribed in this Part, as indicated by documentation retained in the loan file.

(2) In valuing the real estate security, an association shall use the current appraised value of the security property, which may include any expected value of improvements to be financed. "Value" for a real estate loan means market value.

(c) *Purchase of loans from the Federal Savings and Loan Insurance Corporation.* An association may purchase from the Federal Savings and Loan Insurance Corporation any real-estate-related loan guaranteed by the Corporation under a guarantee contract made by the Corporation with the purchasing association.

§ 545.6–1 Insured and guaranteed residential real estate loans.

(a) Notwithstanding any other provision of this Part, loans that are insured or guaranteed by a public mortgage insurer may be made in amounts and with terms and conditions of repayment acceptable to the insuring or guaranteeing agency.

(b) A loan is insured or guaranteed by a public mortgage insurer if:

(1) It comes within the definitions of §§ 541.10 or 541.13 of this Subchapter, or within the provisions of Title X of the National Housing Act; or

(2) It is insured or guaranteed by an agency or instrumentality of a state (i) whose full faith and credit is pledged to support the insurance or guarantee, or (ii) whose insurance or guarantee program is approved by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.

§ 545.6–2 Other residential real estate loans.

(a) *Home loans.*—(1) *General requirements.* Loans on the security of homes or combinations of homes and business property, repayable in regular monthly payments sufficient to liquidate the debt, principal and interest, within the loan term, shall not exceed 90 percent of the value of the security property and shall be repayable within 40 years. Except as otherwise specifically authorized in this Part, after the first payment on a loan described under this paragraph (a) that is secured by property occupied or to be occupied by the borrower, no subsequent required payment shall be greater than any preceding payment. Loans in excess of 80 percent of value made on the security of condominium or cooperative dwellings that are in the process of conversion from rental units, or such loans made in connection with such a conversion, shall be subject to the restriction of paragraph (a)(2)(ii) of this section.

(2) *Ninety-five percent loan-to-value authorization.* The loan-to-value limitation in paragraph (a)(1) of this section shall be 95 percent, if:

(i) The loan contract requires that, in addition to principal and interest payments on the loan, one-twelfth of estimated annual taxes and assessments on the security property be paid monthly in advance to the association;

(ii) The borrower, including a purchaser who assumes the loan, has executed a certificate stating that the borrower occupies, or in good faith intends to occupy, the property (or one dwelling on the property) as the borrower's principal residence; and

(iii) As long as the unpaid balance of the loan exceeds 90 percent of the value of the security property, determined at the time the loan was made, the part of such balance exceeding 80 percent of value is guaranteed or insured by a mortgage insurance company which the Federal Home Loan Mortgage Corporation has determined to be a "qualified private insurer": *provided,* however, that any unpaid loan balance secured by a pledged savings account shall not be required to be guaranteed or insured under this provision.

(3) *Non-monthly-installment loans.* The term-of-years limitation shall be 15 years on loans made with interest payable less frequently than monthly

but at least semi-annually and principal payable less frequently than monthly but at least annually in installments sufficient to retire the debt, both interest and principal, within the loan term, and 40 years on loans made on farm residences or combinations of farm residences and commercial farm real estate with principal and interest payable less frequently than monthly but at least annually in installments sufficient to retire the debt, both interest and principal, within the loan term.

(4) *Loans without full amortization.* (i) *General rule.* Nonamortized loans (loans on which no principal payments are made until the end of the term) and loans that are not fully amortized shall not exceed 60 percent of value and shall be repayable within 5 years, with interest payable at least semiannually.

(ii) *Loans to facilitate trade-in or exchange.* Loans made to facilitate the trade-in or exchange of security property shall not exceed 90 percent of value and shall be repayable within 18 months, with interest payable at least semiannually.

(iii) *Flexible payment loans.* A loan that is secured by property occupied or to be occupied by the borrower may provide for an initial period, not exceeding five years, during which required monthly installment payments shall equal not less than one-twelfth the annual interest rate times the unpaid balance of the loan, and a subsequent period during which required monthly installment payments shall be sufficient to liquidate the debt, both principal and interest, within the loan term. The limitation contained in the last sentence of subparagraph (a)(1) pertaining to maximum payments shall apply separately to the initial period and subsequent period of a flexible payment loan, except to the extent that the loan complies with one of the mortgage plans authorized under §§ 545.6–4 ("Alternative mortgage instruments") or 545.6–4a ("Renegotiable rate mortgages") of this Part. If a flexible payment loan provides for fixed monthly payments in the initial and/or subsequent period(s), the payment schedule must be set forth in the loan contract.

(5) *Pledged account loans.* Loans made on the combined security of real estate and savings accounts may be made in excess of the maximum loan-to-value ratios specified in this paragraph (a), with such excess secured by savings accounts: *provided,* that loans made under subparagraph (a)(2) are subject to the following restrictions:

(i) The loan shall not exceed the appraised value of the real estate;

(ii) The savings account shall consist only of funds belonging to the borrower, members of his family, or his employer; and

(iii) The association shall fully disclose to the prospective borrower the differences (including interest, private-mortgage-insurance costs, and equity interest) between a loan secured by real estate and savings and a loan secured by real estate alone.

(6) *Loans on cooperatives.* Such loans may be made under this paragraph (a), subject to the following requirements:

(i) *Loans on the security of cooperative housing developments ("blanket" loans).* The association shall require that the cooperative housing development maintain reserves at least equal to those required for comparable developments insured by the Federal Housing Administration.

(ii) *Loans on individual cooperative units.* Such loans may be made on the security of (*a*) a security interest in stock, membership certificate, or other evidence of ownership issued to a stockholder or member by a cooperative housing organization; and (*b*) an assignment of the borrower's interest in the proprietary lease or occupancy agreement issued by such organization.

(7) See §§ 545.6–4 and 545.6–4a of this Part for other mortgage plans which may be used for loans authorized under this paragraph (a).

(b) *Multifamily dwelling loans.* Loans on the security of other dwelling units, combinations of dwelling units, including homes, and business property involving only minor or incidental business use, shall not exceed 90 percent of the value of the security property and shall be repayable within 30 years, with interest payable at least semi-annually: *provided,* that loans which are not fully amortized shall not exceed 75 percent of value and shall be repayable within 5 years for non-amortized loans, and with principal and interest payments sufficient to meet a 30-year amortization schedule for partially-amortized loans.

(c) *Loans on unimproved real estate ("acquisition" loans).* Loans on the security of unimproved real estate as defined in § 541.25 of this Subchapter shall not exceed 66⅔ percent of the value of the security property, and shall be repayable in 3 years with interest payable at least semi-annually.

(d) *Development loans.* (1) Loans to finance development of land shall not exceed 75 percent of the value of the security property and shall be repayable within 5 years, with interest payable at least semi-annually. The loan documentation shall contain a preliminary development plan that is satisfactory to the association.

(2) Upon release of any portion of the security property from the lien securing the loan, the principal balance of the loan shall be reduced by an amount at least equal to that portion of the outstanding loan balance attributable to the value of the property to be released. "Value" for the purposes of the preceding sentence is the value fixed at the time the loan was made.

(3) An association may extend the time for payment for an additional period not in excess of 3 years, but no extension may be made unless (i) interest on the loan is current, (ii) the association's board has before it a current appraisal of the security property, and (iii) the outstanding principal balance of the loan is or has been reduced to an amount not over 75 percent of the current value of the security property.

(4) The limitation on loans to one borrower as defined in § 569.9–3 of this Chapter shall be 2 percent of an association's assets with regard to loans on any one development project made under this paragraph (d). A development project includes all primarily residential, recreational, or other facilities in an integrated development plan.

(e) *Loans on building lots and sites.* Loans on the security of building lots and sites ("other improved real estate" as defined in § 541.17(b)) shall comply with the following requirements:

(1) Single-family-dwelling loans for a borrower's principal residence (as evidenced by a borrower's certification of intention, at the time the loan is made, that the property will be so used) shall not exceed 75 percent of the value of the security property and shall be repayable within 15 years, with interest payable at least semi-annually. The loan contract shall provide for monthly payments of principal and interest sufficient to amortize at least 30 percent of the original principal amount before the end of the loan term.

(2) Loans other than for a borrower's principal residence shall not exceed 75 percent of the value of the security property and shall be repayable within 3 years, with semi-annual interest payments beginning not more than 1 year after the initial disbursement.

(3) The provisions of paragraphs (d)(2) and (3) shall apply to this paragraph (e).

(f) *Construction loans.* (1) Construction loans on other improved real estate (as defined in § 541.17(b)) shall not exceed 75 percent of the value of the security property and shall be repayable in 3 years, with interest payable at least semi-annually, except that for construction of single family dwellings, loans on individual structures shall be repayable within 18 months of initial disbursement of applicable loan funds.

(2) Associations shall reserve the right to impose limits on the number of structures under construction at a given time.

(3) The provisions of paragraphs (d) (2) and (3) shall apply to this paragraph (f), except that loan extensions for construction of individual single-family-dwelling structures are limited to 6 months.

(g) *Rehabilitation loans.* Loans to finance substantial alteration, repair or improvement of primarily residential property may be made within the maximum loan-to-value ratios permitted for loans under paragraphs (a) and (b) of this section and shall be repayable within 3 years (18 months for a single family dwelling), with interest payable at least semi-annually.

(h) *Combination loans.* (1) Any loans authorized by this § 545.6–2 may be combined, with the term of each loan beginning at the end of the term of the preceding loan and interest and principal payment requirements as specified in the applicable paragraphs of this section.

(2) Loans made on unimproved real estate (as defined in § 541.25 of this Part), development loans, and loans on other improved real estate (as defined in § 541.17(b)) which are combined with permanent financing loans, or are made to borrowers who have secured permanent financing from other lenders, may be made within the maximum loan-to-value ratios permitted for loans under paragraphs (a) and (b) of this section: *Provided,* that disbursement of loan proceeds in excess of 80 percent of the value of the security property shall not be made until substantial completion of construction.

(3) With respect to a combination of loans to finance development and loans on building lots and sites and/or construction loans, whether or not development has been completed, (i) beginning not more than 3 years after the initial disbursement of loan proceeds for construction purposes, the principal shall be amortized monthly at a rate of at least 1½ percent of that portion of the loan balance applicable to any home, including the building site, and (ii) beginning not more than 4 years after such disbursement, principal shall be amortized monthly at a rate of at least 1½ percent of that portion of the loan balance not applicable to the construction of any home and its building site.

(4) Notwithstanding any other provisions of this § 545.6–2, a combination loan for construction inclusive of acquisition and/or development shall be repayable within 8 years, but such loan may be extended for an additional period not exceeding 3 years.

(i) See § 545.6–5 of this Part for residential loan leeway authority.

4. Delete § 545.6–2a, and revise § 545.6–3 by substituting a new text to read as follows:

§ 545.6–2a Loans on cooperatives.

[Rescinded effective November 17, 1980.]

§ 545.6–3 Home improvement loans.

An association may invest in loans, with or without security, for residential real property alteration, repair or improvement, or for equipping or furnishing residential real property, with installments payable at least quarterly, the first installment due no later than 120 days from the date the loan is made and the final installment due no later than 20 years and 32 days from such date. Installments shall be substantially equal except to the extent that the loan complies with one of the mortgage plans authorized under §§ 545.6–4 or 545.6–4a of this Part.

§ 545.6–4 [Amended].

5. Amend §545.6–4(b) by deleting the phrase "under § 541.9 of this subchapter " in subparagraph (4), and changing the reference from § 545.6–1(a) to § 545.6–2(a) in subparagraph (5) thereof.

§ 545.6–4a [Amended].

6. Amend § 545.6–4a by deleting the phrase "of up to 30 years" in paragraph (b) thereof.

7. Revise §§ 545.6–5 and 545.6–6 by substituting new texts to read as follows:

§ 545.6–5 Leeway authority for loans relating to residential real estate and farms.

(a) *Loans without requirement of security for construction purposes.* In addition to loans in which it may invest under other provisions of this Part, an association may invest an amount not exceeding the greater of its surplus, undivided profits, and reserves or 5 percent of its assets in loans the principal purpose of which is to provide financing with respect to what is or is expected to become primarily residential real estate where the association relies substantially for repayment on: (1) the borrower's general credit standing and forecast of income, with or without other security, or (2) other assurances of repayment, including but not limited to a third-party guaranty or similar obligation.

(b) *Nonconforming secured loans.* In addition to loans in which it may invest under other provisions of this Part, an association may invest an amount not exceeding 5 percent of its assets in loans, advances of credit, and interests therein, secured by residential real estate or real estate used or to be used for commercial farming, which are not otherwise authorized under this Part.

§ 545.6–6 Commercial real estate loans.

(a) Loans (including construction loans) secured by first liens on other improved real estate, as defined in § 541.17(a) and (c) of this Subchapter, shall not exceed 90 percent of the value of the security property, and shall be repayable within 30 years, with interest payable at least semi-annually: *Provided,* that construction loans and nonamortized loans shall not exceed 75 percent of value and shall be repayable within 5 years, and partially-amortized loans shall be repayable with principal and interest payments sufficient to meet a 30-year amortization schedule.

(b) An association's aggregate investment under this section shall not exceed 20 percent of assets.

(c) A loan is considered to be secured by a first lien under this section if it is (i) secured by an interest in real estate in fee or in a leasehold or subleasehold extending or renewable automatically or at the option of the holder or the association for 5 years after maturity of the loan, if, in the event of default, the real estate could be used to satisfy the obligation with the same priority as a first mortgage or first deed of trust in the jurisdiction where the real estate is located; or (ii) secured by an assignment of such loan(s).

(d) See § 545.6–5 for additional authority to invest in commercial farming loans and § 545.6–10 for additional authority to invest in community development loans.

8. Delete §§ 545.6–7, 545.6–8, and 545.6–12, amend paragraph (a) of § 545.6–9, and revise §545.6–10 and paragraph (a) of § 545.6–13, to read as follows:

§ 545.6–7 Insured loans to finance land development.

[Rescinded effective November 17, 1980]

§ 545.6–8 Housing facilities for the aging.

[Rescinded effective November 17, 1980]

§ 545.6-9 Loans on low-rent housing.

(a) *General.* Limitations in this Part relating to maximum loan terms and loan-to-value ratios, except limitations in § 545.6-8, shall not apply to any loan secured by a first lien on real estate which is, or is being constructed, remodeled, rehabilitated, or renovated to be, the subject of (1) an annual contributions contract for low-rent housing under former Sections 23 or 5 of the United States Housing Act of 1937, as amended, or (2) a Housing Assistance Payment (HAP) contract for low-income housing under Section 8 of the United States Housing Act of 1937, as amended, which the mortgagor has agreed in writing to enter into for the maximum term available for the particular project type and financing: *Provided,* no such loan by a Federal association shall exceed 90 percent of the appraised value of the security property or, in lieu of such appraisal, 90 percent of the purchase price if the security property is to be purchased by a local public housing authority, and in no event shall loan proceeds in excess of 80 percent of such appraised value be disbursed to the borrower until the Department of Housing and Urban Development has issued its final approval of the project under the subsidy program. Loans insured under the National Housing Act may be made on terms and conditions permitted by the insuring agency as provided in § 545.6-1 of this Part.

* * * * *

§ 545.6-10 Community development loans and investments.

(a) *General.* A Federal association may invest in real property, or in interests in real property, located within any of the following areas, and in loans on the security of liens, and in other obligations secured by liens, on real property so located:

(1) Any neighborhood strategy area (as defined in 24 CFR 570.301(c)) receiving concentrated development assistance under Title I of the Housing and Community Development Act of 1974, as amended;

(2) Any general location (as specified in 24 CFR 570.306(b)(3)(ii)) which is specified in a community's Housing Assistance Plan (as defined in 24 CFR 570.306) as an area for housing assistance goals and which is receiving such concentrated assistance;

(3) Any urban renewal area (as defined in section 110(a) of the Housing Act of 1949, as amended) receiving such concentrated assistance in order to finish uncompleted urban renewal projects; and

(4) Any locales specified by a community as receiving Urban Development Action Grants or otherwise receiving significant amounts of such concentrated assistance.

(b) *Investment in loans and other obligations secured by liens on real estate.* Such investments shall conform to all limitations in this Part 545 applicable to the type of real estate securing the investments.

(c) *Investments in real estate.* An association may invest up to 2 percent of assets in real property or interests therein described in paragraph (a). Investments may not exceed the appraised value of the property plus usual settlement costs. In determining the 2-percent investment limit, the following rules shall apply:

(1) A reasonable allowance for depreciation computed under the straight-line method may be deducted from the cost of improved real property or investments in improved real property owned by the association;

(2) If a leasehold interest in land is acquired, the amount of the investment as to rental obligations under the lease shall be determined on the basis of the "present value of an annuity due" and for the purpose of such determination, the worth of money shall be deemed to be 10 percent; and

(3) The investment in improvements to land in which the association has a leasehold interest shall be the cost to the association of the improvement, less reasonable allowance for amortization computed under the straight-line method.

(d) Total investment under this section shall not exceed 5 percent of assets.

§ 545.6-12 Nonconforming secured loans and loans without requirement of security.

[Rescinded effective November 17, 1980.]

§ 545.6-13 Farmers Home Administration Rural Housing Program guaranteed loans.

(a) *General.* An association may invest in loans on residential real estate guaranteed under the Farmers Home Administration (FmHA) Rural Housing Program, without regard to other provisions in this Part.

* * * * *

9. Delete §§ 545.7-7 and 545.7-8 and revise § 545.7-6 (a)(2), (b), introductory text of (d), (d)(1), (e)(1), (e)(2) (ii) and (iii), adding a new (e)(3) and (f) to read as follows:

§ 545.7-6 Mobile home financing.

(a) *Definitions used in this section.*

* * * * *

(2) "Mobile home chattel paper"—a document evidencing a loan or interest in a loan secured by a lien on one or more mobile homes and equipment installed or to be installed therein.

* * * * *

(b) *General investment authority.* An association may invest up to 20 percent of assets in mobile home chattel paper and interests therein.

* * * * *

(d) *Inventory financing.* An association may invest in mobile home chattel paper which finances a mobile home dealer's acquisition of inventory, if:

(1) The inventory is held for sale by the dealer in its ordinary course of business;

* * * * *

(e) *Retail financing.* (1) *Insured and guaranteed loans.* An association may invest in retail mobile home chattel paper that is insured or guaranteed, as defined in §§ 541.10 or 541.13 of this Subchapter, or that has a commitment for such insurance or guarantee.

* * * * *

(2) *Conventional loans.*

* * * * *

(ii) the mobile home is or will be located at a mobile home park or other permanent or semi-permanent site;

(iii) the loan is payable within 20 years, in monthly payments which are substantially equal except to the extent that the loan complies with one of the mortgage plans authorized under §§ 545.6-4 or 545.6-4a of this Part; and

* * * * *

(3) *Purchase of retail paper.* With regard to purchase of an interest in retail mobile home chattel paper where the security property is or will be located outside the association's normal lending territory (as defined in § 561.22), the seller of the interest shall be an institution whose accounts or deposits are insured by a Federal agency or a service corporation thereof and the seller (unless the seller is the association's service corporation) shall retain at least a 25 percent interest in each document evidencing a loan secured by the chattel paper.

(f) *Sale of paper.*

(1) All mobile home chattel paper sold by an association shall be sold without recourse, as defined in § 561.8 of this Chapter.

(2) No association may sell mobile home chattel paper if, at the close of its most recent semi-annual period, it has mobile-home-chattel-paper scheduled items (other than assets acquired in a supervisory merger) in excess of 5 percent of its total portfolio in such paper: *provided,* that application may be made to the Board for a waiver of this restriction.

§ 545.7-7 Purchase of participation interests in mobile home chattel paper.

[Rescinded effective November 17, 1980]

§ 545.7-8 Sale of mobile home chattel paper.

[Rescinded effective November 17, 1980]

10. Revise § 545.7-9, to read as follows:

§ 545.7-9 Collateral loans.

An association may make a collateral loan (secured by assignment of secured loans) to the extent that it could, under applicable law and regulations, make or purchase the underlying assigned loan(s).

11. Delete §§ 545.8, 545.8-1, 545.8-6, and 545.8-7, and amend the title of § 545.8-3, as follows:

§ 545.8 Participations.

[Rescinded effective November 17, 1980]

§ 545.8-1 Purchase of loans.

[Rescinded effective November 17, 1980]

§ 545.8-3 Contract provisions for real estate loans.

§ 545.8-6 Lending area.

[Rescinded effective November 17, 1980]

§ 545.8-7 Percentage limitation on real estate loan investments.

[Rescinded effective November 17, 1980]

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 561—DEFINITIONS

11a. Amend § 561.22 by revising paragraph (a), deleting paragraph (b), and redesignating paragraph (c) as paragraph (b), as follows:

§ 561.22 Normal lending territory.

(a) Normal lending territory is the area (1) within the State in which such institution's principal office is located; (2) within any portion of a circle with a radius of 100 miles from the principal office which is outside of such State; and (3) other territory in which the institution was operating on June 27, 1934.

(b) *Definitions.* * * *

PART 563—OPERATIONS

12. Revise § 563.9 to read as follows:

§ 563.9 Nationwide lending.

(a) An insured institution may invest in, sell, purchase, participate or otherwise deal in loans or interests therein on security property located outside its normal lending territory but within the United States or its territories and possessions.

(b) An institution investing in a nationwide loan shall obtain a signed report of appraisal of the real estate security for the loan, prepared by an appraiser having no interest, direct or indirect, in that security or in any loan on that security and whose compensation is not affected by the approval or declining of the loan.

13. Delete §§ 563.9-1 and 563.9-2, as follows:

§ 563.9-1 Participation loans.

[Rescinded effective *November 17, 1980.]*

§ 563.9-2 Sales of interest in loans on real estate located outside normal lending territory.

[Rescinded November 17, 1980]

14. Amend paragraph (b) of § 563.9-3 by deleting the proviso and substituting therefor the following language:

§ 563.9-3 [Amended].

* * * * *

(b) * * * *Provided,* that, notwithstanding any other limitation of this sentence, any such loan may be made if the loan is secured by a lien on low-rent housing, or if the sum of subparagraphs (1) and (2) of this paragraph (b) does not exceed $200,000 and, beginning on January 1, 1982, and annually thereafter, such amount adjusted by the dollar amount that reflects the percentage increase, if any, in the Consumer Price Index during the previous 12 months as shown in the November-to-November index.

15. Revise § 563.9-7, to read as follows:

§ 563.9-7 Loans in excess of 90 percent of value.

(a) An insured institution authorized to make loans in excess of 90 percent of value on the security of real estate comprising single-family dwellings or dwelling units for four or fewer families may do so only if such loans comply with § 545.6-1 or § 545.6-2(a)(2)(iii) of this Chapter.

(b) This section does not apply to loans to facilitate the sale of real estate owned as defined in § 561.15(d) of this Subchapter, nor to investment in Farmers Home Administration Rural Housing Program guaranteed loans complying with § 545.6-13 of this Chapter.

16. Delete § 563.10, to read as follows:

§ 563.10 Appraisal requirements.

[Rescinded effective November 17, 1980]

(Sec. 10, 47 Stat. 725 (12 U.S.C. 1421 et seq.) sec. 5, 48 Stat. 132 (12 U.S.C. 1464), as amended by sec. 401, 94 Stat. 160; secs. 402, 403, 407, 48 Stat. 1256, 1257, 1260, as amended (12 U.S.C. 1725, 1726, 1730). Reorg. Plan No. 3 of 1947, 12 FR 4891, 3 CFR, 1943-48 comp., p. 1071)

By the Federal Home Loan Bank Board.

Robert D. Linder,

Acting Secretary.

[FR Doc. 80-36000 Filed 11-17-80; 8:45 am]

BILLING CODE 6720-01-M

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12 CFR Parts 526, 545 and 563

[No. 80-702]

Maturity of Time Deposits

Dated: November 10, 1980.

AGENCY: Federal Home Loan Bank Board.

ACTION: Final regulations.

SUMMARY: The Federal Home Loan Bank Board has amended its regulations to reduce the minimum period of maturity on time accounts from thirty to fourteen days. This action parallels a similar change made recently in the regulations applicable to banks, and is intended to give parity to savings and loan associations and to increase funds available for home financing.

EFFECTIVE DATE: November 10, 1980.

FOR FURTHER INFORMATION CONTACT: Michael D. Schley (202-377-6444), Office of General Counsel, Federal Home Loan Bank Board, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION: Section 526.3-1 of the Regulations for the Federal Home Loan Bank System (12 CFR 526.3-1) allows member institutions to offer certificate accounts of $100,000 or more that are not subject to an interest rate ceiling if the account has a term of at least thirty days. Similarly, § 526.3 (c) (12 CFR 526.3(c)) refers to a minimum term of maturity of thirty days for public unit accounts at member institutions. The Federal Home Loan Bank Board has amended the language of these two sections and six other related sections by replacing the thirty-day minimum term with a fourteen day minimum maturity period.

This action by the Board parallels a recent resolution by the Board of Governors of the Federal Reserve System that shortened the maturity period for "time deposits", as defined in Regulation D (45 FR 56009, August 22, 1980; 12 CFR 204.2(c)). The amendment to Regulation D was intended to "improve the competitive position of domestic depository institutions vis-a-vis open market instruments and foreign banking offices" (45 FR 56013). The Board believes that a similar change in authority is necessary to assist member institutions in obtaining funds for home financing.

The revision of § 526.3-1 specifically exempts certificate accounts of $100,000 or more with a term of at least fourteen days from the interest rate ceilings of § 526.3. The public unit account provision in § 526.3(c) is revised to conform to the new minimum term restriction of fourteen days.

It is noted that a time account with a maturity shorter than one year and a balance of less than $100,000 is a "regular account" as defined in 12 U.S.C. 526.1(d), because a member institution may not currently offer a higher rate of interest than 5½ percent, the same rate applicable to passbook accounts. (*See* the Depository Institutions Deregulation Committee final rule of October 9, 1980, 45 FR 68640, October 16, 1980; 12 CFR 526.3(a)(1), (10)).

The Board finds that observance of the notice and comment period of 12 CFR 508.12 and 5 U.S.C. 553(b) and the 30-day delay of effective date of 12 CFR 508.14 and 5 U.S.C. 553(d) would be contrary to public policy because of the detrimental economic effect on member institutions and savers that would result from delaying the effective date of this resolution.

Accordingly, the Board hereby amends Part 526, Subchapter B, Part 545, Subchapter C, and Part 563, Subchapter D, Chapter V of Title 12, *Code of Federal Regulations*, as set forth below.

SUBCHAPTER B—FEDERAL HOME LOAN BANK SYSTEM

PART 526—LIMITATIONS ON RATE OF RETURN

1. Amend paragraph (c) of § 526.3 by substituting the number "14" for the number "30" in the phrase "30 days or more" and replacing an obsolete reference to subparagraph (a)(8) with a reference to 12 CFR 1204.104, to read as follows:

§ 526.3 Maximum rates of return payable by members on savings accounts.

(c) *Exceptions as to terms or qualifying periods.* A member may pay a rate of return not exceeding the highest rate permitted under paragraph (a) of this section on (1) a public unit account that is a certificate account with a maturity of 14 days or more or a notice account, or (2) a certificate account that qualifies as a retirement account under subsection 401(d) or 403(a) of the Internal Revenue Code and has a term of 3 years or, in the case of an account issued under subdivision (a)(4)(ii), 30 months; *provided*, that such accounts issued under subdivision (a)(5)(ii) of this section prior to January 1, 1980, or under subdivision (a)(4)(ii) of this section must meet the maturity requirement, and accounts issued under 12 CFR 1204.104 must meet the minimum amount and maturity requirements, prescribed in those provisions.

2. Revise § 526.3-1 by substituting the number "14" for the number "30", to read as follows (the entire paragraph is set forth below for the benefit of the reader);

§ 526.3-1 Certificate accounts of $100,000 or more.

No maximum rate of return shall apply to a certificate account of $100,000 or more ($50,000 or more if the issuing member's home office is in Puerto Rico) with a term of at least 14 days. (The $50,000 minimum shall apply only if the member does not advertise or promote the account outside Puerto Rico.)

SUBCHAPTER C—FEDERAL SAVINGS AND LOAN SYSTEM

PART 545—OPERATIONS

§§ 545.1-1, 545.1-3, and 545.1-4 [Amended]

3. Amend paragraph (f) of § 545.1-1, paragraph (b) of § 545.1-3, and paragraph (c) of § 545.1-4, by substituting the number "14" for the number "30" wherever it appears.

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 563—OPERATIONS

§§ 563.3-1, 563.3-2, and 563.3-3 [Amended]

4. Amend subparagraph (4) of paragraph (b) of § 563.3-1 and subparagraph (4) of paragraph (b) of § 563.3-2 by substituting the number "14" for the number "30" wherever it appears. Amend subparagraph (1) of paragraph (c) of § 563.3-3 by substituting the number "14" for the word "thirty" wherever it appears.

(Sec. 5B, 12 U.S.C. 1425b, 47 Stat. 725; Sec. 5, 48 Stat. 132, as amended (12 U.S.C. 1464); Secs. 402, 403, 48 Stat. 1256, 1257, as amended (12 U.S.C. 1725, 1726); Reorg. Plan No. 3 of 1947, 12 FR 4981; 3 CFR, 1943-48 Comp., p. 1071)

By the Federal Home Loan Bank Board.

Robert D. Linder,

Acting Secretary.

[FR Doc. 80-36003 Filed 11-17-80; 8:45 am]

BILLING CODE 6720-01-M

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12 CFR Parts 541, 545, 561, 563

[No. 80-701]

Investment in Consumer Loans, Commercial Paper and Corporate Debt Securities

Dated: November 10, 1980.

AGENCY: Federal Home Loan Bank Board.

ACTION: Final regulations.

SUMMARY: These regulations implement section 401 of Tile IV of the Depository Institutions Deregulation and Monetary Control Act of 1980, which authorizes Federally-chartered savings and loan associations and mutual savings banks, subject to a 20-percent-of-assets limitation, to make secured or unsecured consumer loans and to invest in, sell, or hold commercial paper and corporate debt securities as defined and approved by the Federal Home Loan Bank Board. These regulations also implement the Federal Financial Institutions Examination Council's recommended "Uniform Policy for Classification of Consumer Instalment Credit Based on Delinquency Status."

EFFECTIVE DATE: November 17, 1980.

FOR FURTHER INFORMATION CONTACT: Ann Hume Loikow, Office of General Counsel, telephone number (202) 377-6448, Federal Home Loan Bank Board, 1700 G Street N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

Background

On July 31, 1980, the Federal Home Loan Bank Board, by Resolution No. 80-468 (45 FR 52177; dated August 6, 1980), proposed regulations to implement a part of section 401 of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("Act"), Pub. L. 96-221, 94 Stat. 132. This section added a new subparagraph (B), which authorizes associations to engage in consumer lending and to invest in, sell, or hold commercial paper and corporate debt securities as defined and approved by the Board, to § 5(c)(2) of the Home Owners Loan Act of 1933 (12 U.S.C. 1464(c)), the category of investments in which Federally-chartered savings and loan associations and mutual savings banks ("associations") may invest up to 20 percent of their assets.

The proposed regulations amended the Rules and Regulations for the Federal Savings and Loan System ("Federal Regulations") to authorize associations to make consumer loans, both directly and indirectly through a dealer, with few limitations, and to invest in commercial paper and corporate debt securities, subject to certain limitations necessary to meet statutory requirements or to help ensure the prudent exercise of this new investment authority. It also amended the Regulations of the Federal Savings and Loan Insurance Corporation ("Insurance Regulations") to implement the Federal Financial Institutions Examination Council's recommended "Uniform Policy for Classification of Consumer Instalment Credit Based on Delinquency Status."

The Board received eighty-five comments from Federal and state-chartered savings and loan associations, mutual savings banks, trade associations, banks, resort community developers, other financial companies, and one public interest group. Most commenters commented favorably on the Board's decision to implement these new investment authorities with a broad regulation that leaves most of the detailed decisions regarding the exercise of these new powers to each institution's management. The bulk of the comments suggesting amendments to the proposal concerned three broad issues: (1) the use of liens on real estate to secure consumer loans; (2) inventory financing and the financing of consumer leasing; and (3) the proposed maturity limitations on investments in corporate debt securities.

Use of Liens on Real Estate To Secure Consumer Loans

Many of those who commented on the proposed regulation wanted to be able to use liens on real estate to secure consumer loans. In the proposal, "consumer loan" was defined as a form of "consumer credit." The latter term includes all those kinds of loans, such as consumer loans, educational loans, unsecured home improvement loans, credit extended in connection with credit cards, and loans in the nature of overdraft protection, which would be subject to the proposed classification system for delinquent consumer instalment credit; however, the term "consumer loan" only included those loans authorized under the new consumer loan provisions of the Act. In order to distinguish between associations' authority to make real estate loans and the new consumer loan authority and to prevent an association's real estate and mobile home loans from being required to be classified under the new loan classification system for delinquent consumer instalment credit, the proposal defined "consumer credit" so as to exclude loans secured by liens on real estate and chattel liens secured by mobile homes. It was thought that all loans secured by homes or real estate should properly fall under the mobile home regulations or the real estate lending regulations.

However, many associations indicated that they wanted to be able to use a lien on real estate to secure a consumer loan without having to go through the substantial documentation required for real estate loans (i.e., appraisals, title searches and insurance, closing). They also wanted more flexibility in payment terms than is allowed under the real estate lending regulations so that they could, for example, make balloon-payment or single-payment consumer loans. Commenters argued that making these loans under the real estate or mobile home lending authority would add to the costs charged to the consumer and substantially lengthen processing time. Finally, in order to be competitive with banks and finance companies, associations indicated a need for an expeditious way in which to make consumer loans as well as for a way in which to provide adequate security for a particular loan.

The Board is persuaded that associations should have the flexibility to use liens on real estate to secure consumer loans and the ability to process them expeditiously. Accordingly, the Board has determined to modify § 545.7–10(b) (relationship of the consumer loan authority to other provisions of Part 545 of the Federal Regulations) and § 561.38 (definition of consumer credit). The amendments are modeled on the Comptroller of the Currency's regulations for national banks. Under the regulation as amended, loans in which the association "relies substantially upon other factors, such as the general credit standing of the borrower, guaranties, or security other than the real estate or mobile home as the primary security for the loan" are to be made as consumer loans. An association will be required to retain appropriate evidence in its files to demonstrate the justification for its decision. Although this regulation as amended leaves much discretion to association management, the Board expects associations generally to treat loans that are made to purchase the real estate securing the loan as real estate loans.

Inventory Financing and Financing Consumer Leasing

A number of commenters requested that the proposal be amended to authorize inventory financing. These commenters argued that associations can compete with other lenders in making certain kinds of loans, such as automobile loans, only if they can obtain dealer referrals and that they need to be able to finance the dealer's inventory in order to induce him to make those referrals. In addition, several commenters requested that the Board authorize associations to finance consumer leases, either by authorizing associations to directly own the property being leased or by authorizing them to finance the lessor's inventory and to receive an assignment of leases. The latter is basically the same as inventory financing. Some commenters also argued that, in addition to being a good way to generate business in certain kinds of consumer loans, primarily for automobiles and other "big ticket" items such as boats and airplanes, the authority to finance dealer inventory or to finance consumer leasing was also a necessary corollary to the granting of authority to indirectly finance consumer loans.

In the preamble to the proposed regulation, the Board took the position that inventory financing was essentially a commercial loan and thus did not fall within the Act's requirement that the loan be "for personal, family, or household purposes," and that authorizing its use would be inconsistent with Congress's intention of giving associations the additional investment powers needed to enable them to become "family finance centers." In addition, the Board pointed out that, although it does authorize inventory financing for mobile homes, the pertinent statutory language is much broader than the language of the consumer loan provisions of the Act.

After reexamining the issue in light of the comments, the Board has concluded that authorizing inventory financing or the type of lease financing that is essentially comparable to inventory financing would be outside the scope of the statute. There appears to be some confusion among commenters as to what Congress did in granting associations the many new powers contained in the Act. A number of commenters appear to feel that Congress's desire to promote competitive equality between various kinds of financial institutions meant that they must share exactly the same powers. However, achieving greater competitive equality does not mean that the various kinds of financial institutions must completely lose their separate identities. Congress gave associations the additional powers needed to enable them to compete for and meet the financial service needs of *individual consumers*, allowing them to offer the consumer the convenience of the "family finance center;" it did not intend to turn associations into commercial banks by allowing them to make commercial loans to businesses.

Furthermore, although it may be argued that inventory financing may ultimately lead to the association being able to finance some loans to individual consumers, there is no guarantee that the association will make the loans to the consumers who purchase from a dealer whose inventory it has financed. The dealer may not always refer customers to the lender or the customers may decide to find their own financing. Over the past few years, consumers have become increasingly credit-conscious and often credit-shop on their own for the best terms. This is one reason why credit unions, for example, which are not authorized to do inventory financing, now finance almost 20% of all automobile loans.

In addition, the Board has concluded that lease financing in which an association acquires title to the property and then directly leases it to the consumer is not authorized by statute. Banks are able to engage in this form of consumer leasing under the "incidental powers" clause of 12 U.S.C. § 24. No similar provision exists in the Home Owners' Loan Act and associations are not otherwise authorized by statute to actually acquire property and lease it. The only exception is found in 12 CFR 545.6–10, pertaining to community development investments.

The Board has, however, determined to adopt as proposed the authorization of associations to do indirect consumer lending. This is an extension of direct lending, i.e., the association is either directly financing the consumer's loan according to some arrangement it has made with a dealer to refer customers to it or it is purchasing a loan from a dealer which it is otherwise authorized to make.

Maturity Limitations on Investments in Corporate Debt Securities

A number of commenters thought that the requirement that the average maturity of an association's portfolio of corporate debt securities not exceed five years was unduly restrictive and should be liberalized or completely eliminated. More comment letters were generated by this issue than by any other. The commenters generally contended that this requirement too heavily skewed an association's authorized purchases of corporate debt securities to short-term securities, while the market primarily offers longer-term ones, most in the 7-to-40 year range, with the largest concentration in the 20-to-40 year range. In addition, these commenters felt that the proposed provision would also effectively prevent associations from investing in new issues, which tend to have the highest interest rates and best yields. Since few issues initially have short terms, associations would be forced to concentrate on older issues, which are heavily discounted, less liquid, and have lower yields. Finally, the commenters thought that this provision limited associations' flexibility to actively manage their portfolios to take advantage of market swings or yield differentials. One major securities dealer was the primary proponent of this view and many associations quoted its comments verbatim.

After analyzing these comments, the Board has determined to retain a short-term average maturity requirement for the following reasons. First, the commenters focused almost entirely on the relationship of current yield to a security's maturity and failed to consider the risks of buying long term bonds and the impact of those risks on associations. Lengthening the maturity of an association's investments in corporate debt securities affects the overall maturity of the association's asset mix, continuing and perhaps increasing the imbalance between the maturities of its assets and liabilities. Given the increasingly short-term nature of associations' liabilities and the long-term nature of much of their mortgage portfolio, the Board would not like to see associations exacerbate this maturity imbalance by concentrating their corporate debt security investments in long-term issues.

Second, although an association increases income volatility by investing in short-term bonds, it would reduce price volatility since the key determinant of price volatility among bonds is the time of maturity, with longer-term bonds being more volatile than shorter-term ones. In recent months, the price volatility of bonds has exceeded that of common stock. Some investment advisers have noted that because of the recent bond price volatility, in large part a reaction to the instability of credit markets caused by inflation and recent changes in the conduct of monetary policy, bonds have become speculative investments, bought more for their potential for rising prices than for the promise of a protected, regular source of interest income. However, as interest rates rise, bond prices fall. Given the wide fluctuations in interest rates over the past year and the inability of investors to correctly forecast what interest rates will be, investments in long-term bonds have become increasingly risky. As a result, the Board believes that associations should be encouraged to invest in shorter-term bonds, an investment strategy which, even though it reduces the opportunity for dramatic profits when rates fall, also reduces the exposure to loss when rates rise.

Third, the fact that most bonds sell at discounts from par does not mean that associations will be unduly penalized by the regulation's average maturity requirement. Because of the record high interest rates over the past year, more than 90 percent of all outstanding corporate bonds are selling at a discount. However, although discounts have lower yields at maturity than do par or premium bonds because of certain tax considerations that do not apply to associations, there is a considerable supply of moderate discount bonds and medium-term notes at near-current coupons that associations may purchase. Furthermore, the yield giveup on current coupons versus discount bonds is only approximately 50 basis points, an amount that the Board believes to be reasonable since discount bonds are less susceptible to call than are current coupons.

Fourth, contrary to the belief of many of the commenters and in part as a result of the trends discussed above, there has been a definite trend toward shorter-term bond issues. In the second quarter of 1980, medium-term bonds (5-to-10-year maturities) accounted for almost half of the total of all new bond issues, whereas they were less than a third of the first quarter 1980 volume and less than one-quarter of the 1976–1979 total issuance. There has been also a substantial issuance of corporate notes rather than bonds since 1974 and many outstanding corporate bonds have aged. As a result, more than $50 billion in corporate bonds with maturities of less than five years exists today, so the maturity averaging process should not be as difficult as some of the commenters contended.

Finally, the older issues that associations would be eligible to purchase under this regulation are not necessarily illiquid since, in addition to the growing market for new issues with medium-term maturities, there is a sizeable secondary market for issues with short maturities. While some outstanding issues may have thin markets, there are sufficient numbers of issues outstanding that have well-developed secondary markets. Furthermore, keeping the maximum maturity of the portfolio low reduces the likelihood of the need for liquidation of holdings since a portfolio with a balanced maturity structure will constantly generate cash flow through principal redemption as well as through interest payments.

In summary, the Board has concluded that its regulation correctly considers the risks of investment in long-term corporate debt securities on associations' existing asset and liability mix and that a short-term average maturity requirement will give associations some flexibility while encouraging prudent investments in shorter-term securities. However, because the Board has noted the larger number of new issues with maturities is the 5-to-10 year range, it has decided to slightly modify the average maturity requirement by increasing it from five to six years. This should allow associations to more easily participate in the new issue market while helping to correct the imbalance in the maturities of their assets and liabilities.

A number of other issues mentioned in the comment letters are addressed briefly below:

"Natural Person" Requirement

A number of the commenters who requested that the Board authorize associations to do inventory financing also requested it to delete from its definition of "consumer loan" and "consumer credit" the requirement that the loan be made to a "natural person." These commenters wished to be able to use the consumer loan authority to make "consumer loans" to non-profit organizations, family farms, small businesses, professional corporations, and the like. In essence, as in the case of inventory financing, these commenters wanted to be allowed to make business loans. Since the purpose of the "natural person" requirement is to ensure that loans made under the "consumer loan" authority go to living persons in their individual capacities, the Board has rejected the suggestion to delete the "natural person" requirement. To do anything else would be contrary to the purpose and clear wording of the statute.

Board of Directors Approval of Dealers

There was mixed opinion in the comment letters about the requirement that an association's board of directors be required to approve the dealers with whom the association engaged in indirect consumer lending. Some commenters thought that the provision was a necessary safeguard to the prudent use of this new lending authority, while others thought that it would be cumbersome and that the board of directors should be able to delegate this responsibility.

The purpose of this provision, as stated in the proposed regulation, is to guarantee that the board of directors is aware of the various arrangements that the association has made to make consumer loans and that the association has examined the dealer's reliability and financial responsibility so that such arrangements are prudently and carefully considered. This does not mean that directors are required to investigate individually the background of each dealer; rather, management should conduct the necessary investigation and negotiations and present its conclusions and proposal to the board for its approval. Thus, this requirement merely ensures that the board of directors does have actual notice of such arangements and has formally voted, as reflected in its minutes, to authorize the association to engage in indirect lending with a particular dealer. The Board has decided to retain this provision as proposed.

Financing Timesharing Interests in Real Estate

The Board received comments from a number of developers of resort communities and from their trade association urging the Board to clarify the statement in the preamble to the proposed regulation that associations would be authorized to finance the purchase of interval-ownership interests in real estate as unsecured consumer loans. In particular, these commenters were concerned about whether associations would also be able to finance the other ownership and various "right-to-use" forms of timesharing.

As noted in the preamble to the proposed regulation, a substantial portion of the loans made to finance these interests in real estate are made for the purchase of benefits and services in addition to the real estate itself, and this portion, which is not secured by the real estate, must be considered to be an unsecured consumer loan which an association will now be authorized to make under 12 CFR § 545.7–10. The Board intends that any of the various kinds of timesharing, whether of an ownership or "right-to-use" form, may be financed as a consumer loan under this new authority. However, because of the administrative difficulties in separating the real estate portion from the non-real estate portion of such loans, the total amount of such loans should be considered to be an unsecured consumer loan if secured solely by the borrower's interest in the real estate purchased. This conforms to the current practices for financing the purchase of these interests. Since purchase prices commonly range between $1,000 and $15,000, with the average price of one week in an ownership plan at $4,050 and in a right-to-use plan at $3,430, this treatment should not inhibit the making of these kinds of loans.

An association may file a lien against the borrower's interest in such property if it wishes, but the Board expects that it will rely primarily on the borrower's creditworthiness or other assets to ensure repayment of the loan. For the purposes of the limitation on unsecured consumer loans to one borrower, however, the total amount of a timesharing loan, whether or not secured by the borrower's interest in the real estate purchased, shall be considered as an unsecured consumer loan unless additional security is taken.

Scope of the Term "Corporate"

Several commenters asked if tax-exempt debt securities issued by nonprofit and government-sponsored corporations could be purchased under the authorization to invest in corporate debt securities. It is intended that the term "corporate" be broadly interpreted to include any entity duly incorporated under the laws of any state or of the United States. Thus, any debt securities issued by a domestic corporation, whether taxable or tax-exempt, provided that they conform to the other requirements of § 545.9–4(b), may be purchased by associations under this authority. It should be noted that debt securities issued by government entities that are not in the corporate form may not be purchased under this section.

Since there is no statutory restriction as to who may issue commercial paper, none is contained in the proposed regulation other than the requirement that the issuer be domiciled in the United States. Thus, an association is authorized to buy both taxable and tax-exempt commercial paper, provided that such paper conforms to the various limitations in § 545.9–4(b).

Bankers' Acceptances

Since investments in bankers' acceptances are already authorized by § 545.9(a) as assets which qualify as liquid assets under 12 CFR § 523.10(g), it was suggested that they be deleted from the definition of "commercial paper" in § 545.9–4(a). This suggestion has been adopted.

Investments in Low-rated or Unrated Commercial Paper and Corporate Debt Securities and in Foreign Commercial Paper and Corporate Debt Securities

A few commenters requested that associations be allowed to invest in low-rated or unrated commercial paper and corporate debt securities and in foreign commercial paper and corporate debt securities. The rating requirement, the requirement that the issue be denominated in dollars, and the requirement that the issuer be domiciled in the United States are designed to help ensure the prudent use of the new powers. The majority of commenters favored these restrictions as proposed and the Board has adopted them without a change. However, since their inclusion is not mandated by the Act, the Board will monitor associations' use of this new investment authority and will reexamine these provisions if experience indicates that liberalization is warranted.

Number of Ratings Required

The proposed regulation required that at least two nationally recognized investment rating services rate the commercial paper and corporate debt securities within the appropriate grades. Several commenters said that this requirement was unnecessarily restrictive, since many high-grade issues are only rated by one such service and requiring at least two such ratings would only add to the issuer's expenses. The Board finds these arguments to be persuasive and has determined to modify the provision to require rating by only one such service.

Investment in Open-end Investment Companies

Several commenters requested that associations be allowed to invest in open-end investment companies that invest only in securities in which the association could invest directly. This would enable small associations, in particular, to exercise more easily this new investment power.

Section 401 of the Act authorizes Federal associations to invest the shares or certificates of such companies, provided that their portfolios are restricted to investments in which an association by law or regulation may, without limitation as to percentage of assets, invest. Since association investments in commercial paper and corporate debt securities are subject to a 20-percent-of-assets limitation, they would not fall within this provision. Therefore, the Board has determined to authorize such indirect investments as part of this regulation and has so amended § 545.9–4(a).

An association will be authorized to invest in the shares of an open-end investment company, registered with the Securities and Exchange Commission, whose portfolio is restricted solely to investments an association is authorized to make under this or other regulations or law. This means that such company's investments in commercial paper and corporate debt securities must conform to the limitations contained in § 545.9–4(b). The limitation on investments in the issues of one issuer, contained in § 545.9–4(b)(3), has been modified, though, because of the impracticability of applying this requirement to an investment in the shares of these investment companies. As a result, an association need not count these investments when it determines whether it has complied with this requirement; rather, an association may not invest an amount exceeding five percent of its assets in the shares of any one such investment company. In addition, an association that invests in the shares of these companies should note that the six year average maturity test for investments in corporate debt securities applies to its portfolio, not to that of the investment company.

Scheduled Items and the Classification System

The comments overwhelmingly favored the proposed classification scheme for delinquent consumer installment credit. As the Board noted in the preamble to the proposed regulation, the principal provision that would be affected by the higher rate of delinquencies found in the usual consumer loan program is the scheduled-items computation, which has been amended to include all of an association's "slow consumer loans". Those who suggested alternatives for including slow consumer loans within the scheduled-items computation were concerned mainly about the effect of delinquent consumer loans upon the various regulatory provisions that have been deleted by Board Resolution No. 80–700 (i.e., the "4%" provisions on nationwide lending, participation loans, etc., in 12 CFR §§ 545.6–12, 563.9, 563.9–1, and 563.9–2).

Since the purpose of the scheduled-items computation is to reflect accurately the soundness of an association's portfolio, the Board has decided to retain this provision as proposed. In the Board's view, the few remaining provisions left in the regulations, other than the net worth requirements, in which scheduled items affect associations' investment authority do not warrant special rules for slow consumer loans that are to be included in scheduled items.

Limitation on Unsecured Consumer Loans to One Borrower

It was suggested that this provision might be too restrictive, particularly where new associations with very low net worth and assets are concerned. A minimum level of $2,500–$3,000 in unsecured consumer loans to the same borrower was recommended, even if the association did not meet the basic test contained in § 545.7–10(c). This suggestion has been adopted and every association, regardless of its net worth or asset position, will be able to make at least $3,000 in unsecured consumer loans to the same borrower. This amount will be increased each January 1, beginning in January, 1982, by the dollar amount that reflects the percentage increase, if any, in the Consumer Price Index over the past twelve months as shown in the November-to-November index.

Charge-Off of Consumer Credit Classified as a Loss

Several commenters questioned the proposed regulation's requirement that consumer credit classified as a loss be charged either to the association's net worth or to its current earnings. The Board has revised this section to require that the loss be charged off only against the association's current earnings. In conformance to the definition of "net income" contained in § 563c.12 of the Insurance Regulations, all such losses should be charged to current earnings. However, associations wishing to establish a valuation or bad debt allowance for such losses may do so by a charge to the applicable non-operating expense account, and losses may be charged to such allowance account.

Other Changes

Several other changes, primarily of a clarifying nature, have been made in the regulations:

(1) The definition of "consumer loan" was amended to clearly indicate that credit extended in connection with credit cards and loans in the nature of overdraft protection are not "consumer loans" and are not to be counted within the 20 percent-of-assets limitation, even though they are forms of "consumer credit" and must be included in the loan classification system.

(2) The definition of "open-end consumer credit" was amended to conform to that of "open-end credit" contained in regulation Z.

(3) An explanation of "marketable" was added to the definition of corporate debt security.

(4) Two changes were made in the limitations on investments in convertible corporate debt securities. First, the requirement that the security be traded on a national exchange was clarified. The word "securities" was added between "national" and "exchange" to make it clear that this term is to be defined as those exchanges registered with the Securities and Exchange Commission as "national securities exchanges" under 15 U.S.C. § 78c(a)(1).

Second, the Board has adopted an additional limitation, requiring associations, at the time of purchase of such securities, to write down the cost of the securities to the investment value of the securities considered independently of the conversion feature. This provision is modelled on the Comptroller of the Currency's regulation on investments in convertible securities and ensures that the bond aspects of the security remain primary, since associations are only authorized by the Act to invest in "debt securities" and not to invest in equity issues.

The Board finds that a 30-day delay of effective date pursuant to 12 CFR 508.14 and 5 U.S.C. 553(d) is unnecessary, as the amendments implement a statutory revision and relieve current regulatory restrictions.

Accordingly, the Board hereby amends Parts 541 and 545, Subchapter C, and Parts 561 and 563, Subchapter D, Chapter V of Title 12, Code of Federal Regulations, as set forth below.

SUBCHAPTER C—FEDERAL SAVINGS AND LOAN SYSTEM

PART 541—DEFINITIONS

1. Add new §§ 541.25, 541.26, 541.27, and 541.28, to read as follows:

§ 541.25 Consumer loan.

A secured or unsecured loan to a natural person for personal, family, or household purposes. Such loan is a type of consumer credit, as defined in § 561.38 of this Chapter, and may be made as either open-end or closed-end consumer credit, as defined in §§ 561.39 and 561.40, but does not include credit extended in connection with credit cards and loans in the nature of overdraft protection.

§ 541.26 Loans.

Obligations and extensions or advances of credit; and any reference to a loan or investment includes an interest in such a loan or investment.

§ 541.27 Commercial paper.

Any note, draft, or bill of exchange which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

§ 541.28 Corporate debt security.

A marketable obligation, evidencing the indebtedness of any corporation in the form of a bond, note and/or debenture which is commonly regarded as a debt security and is not predominantly speculative in nature. A security is marketable if it may be sold with reasonable promptness at a price which corresponds reasonably to its fair value.

PART 545—OPERATIONS

2. Add a new § 545.7–10, to read as follows:

§ 545.7-10 Consumer loans.

(a) *General.* A Federal association may make direct or indirect consumer loans: *Provided,* that (1) at any one time the total investment made under this section and § 545.9–4 of this Part ("Commerical paper and corporate debt securities"), added together, shall not exceed 20 percent of an association's assets; and (2) that before indirect loans are made through a dealer, the dealer is approved by the association's board of directors. The authority to make a consumer loan includes the authority to originate purchase, sell, service, and participate in such loans: *Provided,* that such loans conform to the provisions of this section and the association's written underwriting standards.

(b) *Relationship to other provisions of this Chapter.* If a loan that may be made under this section is also authorized to be made under another section, which may have different percentage-of-assets and other limitations or requirements, an association shall have the option of choosing under which applicable section the loan shall be made.

(c) *Limitation on unsecured loans to one borrower.* The total balances of all outstanding loans, as defined in § 563.9–3(a)(2) of this Chapter, that may be made under this section in unsecured loans to one borrower, as defined in § 563.9–3(a)(1), is limited to the lesser of ¼ of one percent of an association's assets or five percent of its net worth: *Provided,* that an association may make up to $3,000 in unsecured loans to any one borrower and, beginning on January 1, 1982, and annually thereafter, such amount shall be adjusted by the dollar amount that reflects the percentage increase, if any, in the Consumer Price Index during the previous twelve months as shown in the November-to-November index.

§ 545.9-1 [Amended]

3. Delete subparagraph (a)(3) of § 545.9–1 and renumber subparagraphs (a)(4) through (8) as (a)(3) through (7), respectively.

4. Add a new § 545.9–4, to read as follows:

§ 545.9-4 Commerical paper and corporate debt securities.

(a) *General.* A Federal association may invest in, sell, or hold commerical paper and corporate debt securities, including corporate debt securities convertible into stock, subject to the limitations set forth in paragraph (b): *Provided,* that at any one time the total investment made under this section and § 545.7–10 ("Consumer loans"), added together, shall not exceed 20 percent of an association's assets. An investment under this section includes the investing in, redeeming, or holding of shares in any open-end management investment company which is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and whose portfolio is restricted by such management company's investment policy, changeable only if authorized by shareholder vote, solely to the investments that an association is authorized to invest in under this section and other regulations or law.

(b) *Limitations.* (1) As of the date of purchase, as shown by the most recently published rating made of such investments by at least one nationally recognized investment rating service, the commerical paper must be rated in either one of the two highest grades and the corporate debt securities must be rated in one of the four highest grades.

(2) The commerical paper or corporate debt securities shall be denominated in dollars and the issuer shall be domiciled in the United States.

(3) At any one time, an association's total investment in the commerical paper and corporate debt securities of any one issuer, or issued by any person or entity affiliated with such issuer, shall not exceed one percent of the association's assets: *Provided,* that this provision shall not apply to investments in the shares of an open-end

management investment company. In such cases, an association's total investment in the shares of any one such company shall not exceed five percent of the association's assets.

(4) Investments in corporate debt securities convertible into stock are subject to the following additional limitations: (i) Purchase of securities convertible into stock at the option of the issuer is prohibited; (ii) at the time of purchase, the cost of such securities must be written down to an amount which represents the investment value of the securities considered independently of the conversion feature; (iii) such securities must be traded on a national securities exchange; and (iv) associations are prohibited from exercising the conversion feature.

(5) At any one time, the average maturity of an association's portfolio of corporate debt securities may not exceed six years.

(6) An association shall maintain information in its files adequate to demonstrate that it has exercised prudent judgment in making investments under this section.

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 561—DEFINITIONS

5. Amend paragraph (a) of § 561.15, to read as follows:

§ 561.15 Scheduled items.

The term "scheduled items" means:

(a) Slow consumer credit, slow loans (other than loans specified in paragraph (b) of this section).

* * * * *

6. Add new §§ 561.16a, 561.16b, 561.38, 561.39, and 561.40, to read as follows:

§ 561.16a Slow consumer credit.

The term "slow consumer credit" means closed-end consumer credit delinquent 90 to 119 days (4 monthly payments) and open-end consumer credit delinquent 90 to 179 days (4-to-6 zero billing cycles). For the purposes of computing delinquency, a payment of 90 percent or more of the contractual payment will be considered as a full payment. If an association can clearly demonstrate that repayment would occur regardless of delinquency status—for example, the loan is well-secured by collateral and is in the process of collection; the loan is supported by a valid guarantee or insurance; or it is a loan where the claims have been filed against a solvent estate—then such loan need not be classified as "slow consumer credit." The following table illustrates the delinquency computation:

Closed-end consumer credit

Due date	Period	Delinquency status	Classification
3/10	3/10-4/09	Not delinquent	
4/10	4/10-5/09	30 days or 2 payments	
5/10	5/10-6/09	60 days or 3 payments	
6/10	6/10-7/09	90 days or 4 payments	Slow.

Open-end consumer credit

Statement	Day	Zero billing cycle	Payment record	Days delinquent	Classification
1	1			0	
2	30	1	No payment	*5	
3	60	2	No payment	30	
4	90	3	No payment	60	
5	120	4	No payment	90	Slow.
6	150	5	No payment	120	Slow.
7	180	6	No payment	150	Slow.

* For purposes of illustration, assume consumer has 25 days in which to pay before payment is considered delinquent.

§ 561.16b Consumer credit classified as a loss.

The term "consumer credit classified as a loss" means closed-end consumer credit delinquent 120 days or more (5 monthly payments or more) and open-end consumer credit delinquent 180 days or more (7 zero billing cycles or more). For the purposes of computing delinquency, a payment of 90 percent or more of the contractual payment will be considered as a full payment. If an association can clearly demonstrate that repayment would occur regardless of delinquency status—for example, the loan is well-secured by collateral and is in the process of collection; the loan is supported by a valid guarantee or insurance; or it is a loan where claims have been filed against a solvent estate—then such loan need not be classified as a loss. The following table illustrates the delinquency computation:

Closed-end consumer credit

Due date	Period	Delinquency Status	Classification
3/10	3/10-4/09	Not delinquent	
* *	*	* *	* *
6/10	6/10-7/09	90 days or 4 payments	Slow.
7/10	7/10-8/09	120 days or 5 payments	Loss*.
8/10	8/10-9/09	150 days or 6 payments	Loss*.

Open-end consumer credit

Statement	Day	Zero billing cycle	Payment record	Days delinquent	Classification
1	1			0	
* *	*	*	*	*	*
7	180	6	No payment	150	Slow.
8	210	7	No payment	180	Loss*.
9	240	8	No payment	210	Loss*.

*Charge-off as required by § 563.46 occurs.

§ 561.38 Consumer credit.

Credit extended to a natural person for personal, family, or household purposes, including loans secured by liens on real estate and chattel liens secured by mobile homes: *Provided*, the association relies substantially upon other factors, such as the general credit standing of the borrower, guaranties, or security other than the real estate or mobile home, as the primary security for the loan. Appropriate evidence to demonstrate justification for such reliance should be retained in an association's files. Among the types of credit included within this term are consumer loans; educational loans; unsecured loans for real property alteration, repair or improvement, or for the equipping of real property; loans in the nature of overdraft protection; and credit extended in connection with credit cards.

§ 561.39 Open-end consumer credit.

"Open-end credit" as defined in Regulation Z (12 CFR 226.2(x)).

§ 561.40 Closed-end consumer credit.

Consumer credit other than open-end consumer credit.

PART 563—OPERATIONS

7. Add a new § 563.46, to read as follows:

§ 563.46 Charge-off of consumer credit classified as a loss.

When consumer credit is classified as a loss, as defined in § 561.16b of this Subchapter, it shall be charged against the association's current earnings.

(Sec. 5(c)(2)(B), 48 Stat. 132, as amended by Title IV, § 401, Public Law 96-221, 94 Stat. 151; § 5(d), 48 Stat. 132, as amended (12 U.S.C. 1464(d)); §§ 402, 403, 48 Stat. 1256, 1257, as amended (12 U.S.C. 1725, 1726); Reorg. Plan No. 3 of 1947, 12 FR 4981, 3 C.F.R. 1943-48 Comp., p. 1071)

By the Federal Home Loan Bank Board.

Robert D. Linder,

Acting Secretary.

[FR Doc. 80-36002 Filed 11-17-80; 8:45 am]

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12 CFR Parts 561 and 563

[No. 80-694]

Net Worth Amendments

Dated: November 6, 1980.

AGENCY: Federal Home Loan Bank Board.

ACTION: Final rule.

SUMMARY: The Board has amended the net worth requirements imposed on institutions the accounts of which are insured by the Federal Savings and Loan Insurance Corporation by (1) replacing the current net worth requirement of five percent of insurable accounts plus five percent of secured borrowings with a requirement of four percent of liabilities, (2) eliminating the Asset Composition and New Worth Index plus the five percent of secured borrowings requirement, (3) providing for up to a ten percent reduction in the otherwise applicable net worth requirement proportionate to the amount of long-term debt, flexible-yield mortgages and short-term liquid assets held, and (4) providing a limited exemption from the net worth and reserve requirements for institutions that sell residential mortgages carrying an interest rate of seven and one-half percent or less. These amendments also reduce the current statutory reserve requirement from an amount equal to five percent of insured accounts to an amount equal to four percent of insured accounts.

EFFECTIVE DATE: November 17, 1980.

FOR FURTHER INFORMATION CONTACT: Jerry Hartzog, Office of Policy and Economic Research (telephone number: (202) 377-6782), or Kenneth F. Hall, Office of General Counsel (telephone number: (202) 377-6466), Federal Home Loan Bank Board, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION: On July 24, 1980, the Federal Home Loan Bank Board proposed amendments to its regulations pertaining to reserve accounts (FHLBB Res. No. 80-445; 45 FR 50797 (1980)). A total of 85 comment letters were received during the public comment period, which ended on September 29, 1980, from Federally and State-chartered savings and loan associations, trade groups, the Federal Home Loan Banks, and a mortgage insurance company trade association. The proposed amendments provided for the following changes:

(1) replacement of the current net worth requirement of 5 percent of insurable accounts plus 5 percent of secured borrowings with a requirement of 4 percent of all liabilities;

(2) elimination of the Asset Composition and Net Worth Index plus the 5 percent of secured borrowings requirement;

(3) reduction by up to 10 percent of the otherwise applicable net worth requirement in proportion to the amount of long-term debt, flexible-yield mortgages and short-term liquid assets held by an association;

(4) limited exemption from the net worth and statutory reserve requirements for institutions that sell residential mortgages carrying an interest of 7½ percent or less; and

(5) reduction of the statutory reserve requirement from 5 to 4 percent of insured accounts.

The proposed amendments were generally supported by a majority of the commenters, although many made recommendations for modification or clarification of one or more of the provisions. After reviewing the comments received and other available information, the Board has determined to adopt the proposed amendments substantially as proposed, as described below.

Replacement of Current Net Worth Requirement With a Liability Test

As stated in the proposal, the reason for the proposed change from a base keyed only to savings to a liabilities base, which includes both savings and borrowings, is a concern that the future growth of non-deposit sources of funds will make a savings-based test increasingly inadequate as an indicator of financial soundness. Due to increasing competition from non-depository institutions such as money market funds, the planned phase-out of deposit rate controls and the rate differential, and a projected strong demographic demand for housing and mortgage loans in the 1980s, the rate of growth of deposits in the future is likely to be insufficient to meet the demand for mortgage loans. It is expected, therefore, that associations will increasingly utilize non-deposit sources of funds to eliminate that short-fall, particularly in light of recent revisions of the Board's outside borrowing regulations that provide greater flexibility for associations to use outside sources of funds. Because this would mean the amount of savings as a proportion of total liabilities will decrease, the Board believes that total liabilities will prove to be a better measure of the reserve needs of insured institutions than the current savings base.

In the proposed regulation, "liabilities" was described as all on-balance-sheet liabilities of an insured institution, including the unpaid principal amount of all outstanding borrowings (including borrowings from a Federal Home Loan Bank or a State-chartered central reserve institution), whether secured or unsecured and regardless of maturity. Many commenters suggested that liabilities be defined to exclude loans in process, deferred fees, accounts payable, escrow accounts, and other non-interest-bearing liabilities. It was argued that these are not "true" liabilities, although they are carried on the liabilities side of a balance sheet, and thus should not be included in the base used to establish the net worth requirement.

The Board, however, has determined to use total liabilities, which, by definition, is equal to the difference between total assets and net worth and will include all items that appear on the liabilities side of a balance sheet. The Board believes that a base comprised of all liabilities, with no exceptions, is the most appropriate base for purposes of calculating the net worth requirement because the purpose of that requirement is to serve as a measure of the size of an institution rather than of the amount of reserves that should be maintained against various types of liabilities. As such, the net worth requirement is a signal to the Board of possible capital adequacy problems. Enforcement of the requirement varies with the nature of the problems. Given this function of the requirement, the Board believes it should not distinguish between different types of liabilities.

Currently, the Board permits associations to determine the base on which the net worth requirement is calculated to be an average of the balance during the current year plus the balances during the previous four years (12 CFR 563.13(b)(2)(ii)). Under the proposed regulation, this averaging would not have been permitted for liabilities other than checking, tax and loan, and savings accounts. All of the commenters who addressed this matter favored averaging for the entire liabilities base. The Board agrees that averaging should be permitted for all liabilities, and the final regulation provides accordingly.

Since changing to a liabilities standard enlarges the base against which the percentage requirement is applied, leaving the percentage at five percent would result in an increase in the net worth requirement for insured institutions. The Board believes it would be inappropriate at this time to increase the net worth requirement and, therefore, has determined to adopt a percentage requirement of four percent, as proposed. Since the Board is reducing the percentage requirement, the Board believes it is unnecessary to provide for a gradual phasing-in of the new requirement, as a number of commenters had suggested. The Board understands that a very small number of institutions may experience an immediate increase in the net worth requirement as a result of these amendments. While this is unavoidable, the Board is prepared to exercise its supervisory discretion in the case of undue increases in the requirement.

Elimination of Asset Composition and Net Worth Index

The current net worth regulation provides that insured institutions shall maintain a level of net worth calculated in accordance with the Asset Composition and Net Worth Index ("ACNWI") (see 12 CFR 563.13(b)(2)) plus five percent of secured borrowings with an original stated maturity of more than one year (see 12 CFR 563.13(b)(4)), if such a level is greater than that based on the percentage-of-savings test. Approximately 22 percent of insured institutions utilize the ACNWI while the remainder employ the savings-based test.

The Board has determined to eliminate the ACNWI, a change the Board believes will significantly simplify the reserve regulation. Currently, institutions must calculate the results of both the ACNWI test and the five-percent-of-savings test. Pursuant to the amendment, institutions will only have one net worth test to meet. This simplification is in accordance with the Board's continuing commitment to meet the simplification objective of Executive Order 12044 ("Improving Government Regulations") as well as the requirements of Section 803(3) of the Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub. L. No. 96–221, 94 Stat. 132 (1980)), which requires that, to the maximum extent possible, regulations shall minimize "compliance costs, paperwork, and other burdens on the financial institutions, consumers, and public * * *."

Although a number of commenters suggested that the ideal measure of reserve needs would be based on the risk of holding various types of assets, most recognized the difficulty of measuring the relative riskiness of individual asset categories. The purpose of the ACNWI requirement has been to control excessive risk-taking by making an institution's net worth requirement vary with the riskiness of the types of assets held by the institution. It has proved quite difficult, however, to establish reserve requirements for particular types of assets that accurately reflect the comparative risks of holding those assets. In addition, the risks of holding various types of assets tend to change over time, necessitating a continuing assessment of the risks associated with each type of asset. In light of these problems with the ACNWI, the Board believes its usefulness and practicality are limited. The Board notes the past year has indicated that interest rate risk caused by rate volatility has a more pronounced effect on the liabilities side of the balance sheet than on the asset side, further limiting the effectiveness of the ACNWI as a net worth tool.

Qualifying Balance Deduction

As proposed, the Board has adopted a reduction of the net worth requirements for insured institutions holding certain qualifying balances. The reduction is structured to reflect the lower reserve needs, due to reduced risk, of institutions that hold such qualifying balances. The amount of the reduction is proportionate to the amount of qualifying balances held by an institution. The concept of a net worth reduction based on qualifying balances was favored by the large majority of commenters.

The qualifying balances, as proposed, included (1) interest-bearing liquid assets, as described in 12 CFR 523.10 (including accrued interest on unpledged assets that qualify as liquid assets under that definition or would so qualify except for their maturities), that will mature within one year, (2) up to one-half of all flexible-yield mortgages (*e.g.*, renegotiable rate mortgages, variable rate mortgages), and (3) fixed-rate, liability sources of funds (e.g., outside borrowings, Federal Home Loan Bank advances, certificate accounts) that have a remaining term to maturity of more than five years. The Board specifically requested comment on whether certificate accounts should be included as a qualifying balance, since such accounts are subject to prepayment and therefore may not exhibit the true characteristics of a long-term liability source of funds. Although a number of commenters suggested that the new penalty for early withdrawals of funds from such accounts should increase the stability of the accounts, other commenters felt institutions still cannot be adequately assured that certificate funds will not be withdrawn prematurely. The Board agrees that, where certificate-holders have the option of withdrawing funds (even though subject to a penalty), certificate accounts cannot be considered sufficiently stable to be included as qualifying balances. Therefore, the final regulation excludes from the qualifying balances set out in the proposal certificate accounts that permit early withdrawal.

Several commenters also suggested that *all* flexible-yield mortgage loans should count as qualifying balances. The Board has determined, however, to retain the 50-percent limit in the final regulation in recognition of the fact that current regulations authorizing the use of such mortgages may not provide associations with sufficient rate flexibility to justify classification of all such mortgages as qualifying balances. The Board has proposed amendments to these regulations that would increase the rate sensitivity of such mortgage instruments. Therefore, the Board at some later time may reconsider the 50-percent limitation contained in the final rule.

Under the regulation, the dollar amount of an institution's net worth requirement will be decreased by three cents for every dollar of qualifying balances held, in an amount up to ten percent of the net worth that would otherwise be required by § 563.13(b)(2). This figure was reached after study of the historical behavior of interest rates and of the manner in which S&L profitability fluctuates. While many commenters suggested that the ten percent limit should be increased to 15 or 20 percent, the Board has determined at this time to retain the limit as proposed.

As the proposal stated, the amendment focuses on the difficulty institutions face of an imbalance between the maturities of their liabilities and their assets. This is the "borrow short/lend long" problem. The maturity imbalance of an institution is the difference between the average duration (or effective average maturity) of its assets and the average duration of its liabilities. If an institution's assets and liabilities have equal durations, cyclical fluctuations in interest rates will not cause fluctuations in profitability. The maturity imbalance of the typical savings and loan association causes its cost of funds to fluctuate more widely over the cycle than its asset yield, thereby causing cyclical fluctuations in profitability.

The fact that institutions with maturity imbalance problems will encounter periods of unusually low profits means they must maintain a high net worth level to ensure the availability of sufficient reserve funds during those periods. Conversely, institutions that have maturity-balancing assets and liabilities are less vulnerable to fluctuations in profitability. Therefore, they need not maintain as high a level of reserves.

In the past, restricted asset and liability powers made it difficult for many insured institutions to alleviate maturity imbalances. At present, however, due to expanded borrowing authority, flexible-yield mortgage authority, and a growing control over deposit composition resulting from the phase-out of deposit rate controls, the Board believes these associations have the ability to begin to alleviate their maturity imbalances. Through this amendment, the Board seeks to structure the net worth requirements to reflect the reserve needs of institutions holding maturity-balancing assets and liabilities and to provide institutions with maturity imbalance problems with an incentive for restructuring their holdings of assets and liabilities to make cyclical fluctuations in profitability more manageable.

Limited Exemption Relating to Sale of Mortgages

Currently, many insured institutions hold a significant number of low-interest, fixed-rate mortgage loans. Since today's substantially higher market rates require these institutions to pay more for the money they use to make mortgages, they are finding themselves in the midst of an earnings squeeze. This situation will not ease until the amount institutions take in as income matches more closely both the amount they pay to depositors to attract savings and the cost of their borrowings.

The Board is concerned with the detrimental effects this earnings squeeze has had on the nation's mortgage market. Therefore, the Board has determined to provide a limited exemption from the net worth and reserve requirements relating to the sale of mortgages with interest rates of seven and one-half percent or below. Without such exemption, fewer institutions would be able to sell their low-yielding mortgages because the losses they would incur from such sales would reduce their net worth and reserves below the regulatory minimums. This amendment, which received much favorable comment, would provide insured institutions with a means of reducing the number of low-yielding mortgages in their portfolios and, thus, of improving their income streams.

The amended regulation grants a limited exemption subject to the following conditions:

(1) failure to meet the minimum net worth and reserve requirements would result from losses from the sale of fixed-rate residential mortgages that have an original interest rate of seven and one-half percent or lower and that have a remaining term at the time of sale of at least five years;

(2) the total book value of such mortgages sold does not exceed ten percent of the total book value of the institution's residential mortgage assets, and the book value of such mortgages sold in any one fiscal year does not exceed five percent of the total book value of the institution's residential mortgage assets;

(3) all of the proceeds of such sales are reinvested in residential mortgage loans within 90 days;

(4) the regulation may not be used to reduce the institution's statutory reserve to less than three percent;

(5) the exemption shall be effective for no more than five years from the date of the sale in connection with which the exemption is granted; and

(6) the institution must maintain complete records of all transactions undertaken pursuant to the regulation.

The exemption is also conditional on the institution establishing and maintaining a plan setting forth (1) that all conditions set out above shall be met, (2) the benefits, including the cash-flow benefits, the institution expects to gain from the exemption, (3) the institution's plan for building up its net worth to the minimum amount required within five years of the date of the sale in connection with which the exemption is granted, and (4) a summary of any prior sales made pursuant to the exemption provision.

In the proposed regulation, the period required for reinvestment of proceeds from sales of the low-rate mortgages was 60 days. Most commenters felt institutions would be hard-pressed to arrange reinvestments within such a short period of time, and recommended that as much as 120 days be permitted for reinvestment. While the Board notes that, at any point in time, institutions normally have outstanding a number of commitments in which such proceeds can readily be invested, the Board agrees that 90 days would be a more appropriate period for reinvestment. However, the Board wishes to make clear that mortgage loans made with such proceeds must be closed within 90 days; it is not sufficient merely to have such funds committed within that period.

Finally, any sale made pursuant to the exemption provision will have to occur on or before December 31, 1982. Thus, institutions will have a limited time period within which to take advantage of the exemption provision.

Retention of Scheduled-Items Requirement

The proposed regulation will retain the current provision that 20 percent of scheduled items be included as part of the net worth requirement. Although a minority of commenters felt this provision should be deleted, the Board believes the 20 percent requirement should be retained because scheduled items are indicative of risky assets that may default and so result in a loss of principal to an institution. In addition, scheduled items represent already occurring losses in the form of late payments. Finally, it is believed that the amount of scheduled items represents a measure of the level of expertise in loan underwriting by institution management. Retention of the requirement, therefore, will be of value to the Board in assessing the financial soundness of institutions.

Some commenters maintained that retention of this requirement would result in "double-counting" since institutions are also required to establish valuation loss reserves on scheduled items. The Board wishes to make clear, however, that the valuation loss reserve and 20-percent requirements meet two different purposes. The valuation reserve reflects the reduced potential for collecting the full value of a scheduled item, while the 20-percent requirement reflects the increased risk of default on the delinquent loan. Therefore, both reserves are needed to reflect the true status of scheduled items. For example, if an association has a loan with a balance due of $140,000, secured by real estate having an appraised value of $100,000, it would be required to establish a valuation reserve of $40,000. The net scheduled item of $100,000 would still represent an investment in a loan that is 100 percent of appraised value. Because of the increased risk associated with a loan that is both 100 percent of value and a scheduled item, the Board believes that an increase in net worth—in this case, of 20 percent of the $100,000 scheduled items, or $20,000—should also be required.

Reduction of Statutory Reserve Component of Net Worth

Section 403(b) of the National Housing Act (12 U.S.C. 1726(b)), as amended by section 409 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (*supra*), provides that the statutory reserve shall be no greater than six percent nor less than three percent of insured accounts, as determined by the Board. The Board has determined to reduce the existing statutory reserve requirement of five percent (see 12 CFR 563.13(a)(2)) to four percent of insured accounts. This will ensure that the statutory reserve requirement operates in tandem with the net worth requirement, which the Board intends to utilize as its primary measure of the reserve needs of insured institutions.

The Board is also taking this opportunity to make certain technical amendments to the reserve regulations, as amended by FHLBB Res. No. 80-444 on July 24, 1980 (45 FR 50713 (1980)). First, the Board codifies its policy that only permanent stock may be used to meet the statutory reserve and net worth requirements. The Board recognizes, however, that there may be situations where this policy may be too inflexible. Thus, the final regulation provides that redeemable stock may be included in statutory reserve and net worth where redemption is permitted only in the event of a merger, consolidation or reorganization approved by the Federal Savings and Loan Insurance Corporation where the issuing institution is not the survivor, or where redemption is accomplished with proceeds from the issuance of permanent stock. Where redemption would occur because of a merger, consolidation or reorganization, the Corporation would have the opportunity to appropriately condition or withhold approval of the transaction if redemption would cause the resulting institution's net worth position to be unsatisfactory. Second, the amendments clarify the application of the new calculations and the dates on which various account balances should be determined for purposes of calculating the minimum net worth requirement. The final regulations, therefore, amend 12 CFR 561.13 and subparagraphs (a)(3) and (b)(1) of 12 CFR 563.13.

The Board finds that the 30-day delay of the effective date following publication as prescribed in 5 U.S.C. 553(d) and 12 CFR 508.14 is unnecessary because it is in the public interest that insured institutions be authorized to apply the revised reserve requirements immediately.

Accordingly, the Board hereby amends Parts 561 and 563, Subchapter D, Chapter V of Title 12, Code of Federal Regulations, as set forth below.

Subchapter D—Federal Savings and Loan Insurance Corporation

PART 561—DEFINITIONS

1. Amend the first sentence of § 561.13 (12 CFR 561.13) to read as follows:

§ 561.13 Net worth.

The term "net worth" means the sum of all reserve accounts (except specific or valuation reserves), retained earnings, permanent stock, and any other nonwithdrawable accounts of an insured institution, except that capital stock may be included as net worth if it would otherwise qualify as permanent stock but for either a provision permitting redemption in the event of a merger, consolidation or reorganization approved by the Corporation where the issuing institution is not the survivor, or a provision permitting redemption where the funds for redemption are raised by the issuance of permanent stock. * * *

PART 563—OPERATIONS

2. Amend § 563.13 (12 CFR 563.13) as follows:

a. Amend subparagraphs (a)(2) and (a)(5)(i) by substituting the word "four" for the word "five" therein;

b. Amend subparagraph (a)(3) by deleting subdivision (ii) thereof and redesignating subdivision (iii) as new subdivision (ii), as set forth below;

c. Revise subparagraphs (b) (1) through (4) thereof, as set forth below; and

d. Add a new paragraph (d) thereto, as set forth below.

§ 563.13 Reserve accounts.

(a) *Statutory reserve requirement.*

* * * * *

(3) Institutions may count as reserves meeting the reserve requirement those items listed in the definition of net worth, as set forth in § 561.13 of this Subchapter, except that the following items shall be excluded:

(i) Subordinated debt securities, and

(ii) Specific loss reserves.

* * * * *

(b) *Net worth requirement.*

(1) *Calcuation period.* The annual net worth requirement, as set forth in paragraph (b)(2) of this section, shall be established as of the first day of each fiscal year and shall be met on the annual closing date of the year; *provided*, that institutions shall change to the beginning-of-year calculation by January 1, 1983, or sooner, but that if such change is made prior to that date, there may be no reversion to the end-of-year calculation.

(2) *Minimum required amount.* On the annual closing date on the twentieth anniversary of insurance of accounts and on each annual closing date thereafter, an insured institution shall have net worth at least equal to the sum of (i) four percent of the amount on the date specified in paragraph (b)(1) of this section or of the average amount on such date and on the corresponding date(s) of one or more of the four immediately preceding fiscal years (provided all such dates are consecutive) of all liabilities (*i.e.*, total assets minus net worth) of the institution, plus (ii) an amount equal to 20 percent of the institution's scheduled items. Commencing with the annual closing date after the fiscal year in which a certificate of insurance is issued, each insured institution that has not reached the twentieth anniversary of insurance of accounts shall have a net worth at least equal to the sum of the amount required by (i) above multiplied by a fraction of which the numerator is the number of consecutive years of insurance of accounts and the denominator is twenty, plus an amount equal to 20 percent of the institution's scheduled items.

(3) *Maintenance of minimum level.* Institutions shall maintain (until the next annual closing date) net worth at least equal to the dollar amount required at the last closing date.

(4) *Qualifying balance deduction.* The amount of the minimum net worth requirement imposed by paragraph (b)(2) of this section will be reduced by three cents for each dollar of "qualifying balances" held by the institution in an amount not exceeding ten percent of the amount of net worth that would otherwise be required by paragraph (b)(2). "Qualifying balances," as used in this paragraph, means (i) interest-bearing liquid assets, as described in § 523.10 of this Chapter (including accrued interest on unpledged assets that qualify as liquid assets within that definition or that would so qualify except for their maturities), provided that they will mature within one year, (ii) up to one-half of all mortgages on which the interest rate may fluctuate, and (iii) fixed-rate, liability sources of funds (including outside borrowings and Federal Home Loan Bank advances but excluding certificate accounts permitting withdrawal of account funds prior to maturity) that have a remaining term to maturity of more than five years.

* * * * *

(d) *Exemption relating to sale of mortgages.* An insured institution shall not be required to meet the minimum net worth requirement set out in paragraph (b)(2) of this section or the statutory reserve requirement set out in paragraph (a)(2) of this section, to the following extent and subject to the following conditions:

(1) Failure to meet the minimum net worth and reserve requirements shall result solely from losses recognized upon the sale of fixed-rate residential mortgages that have an original interest rate of seven and one-half percent or below and that have a remaining term at the time of sale of at least five years;

(2) The total book value of such mortgages sold shall not exceed ten percent of the total book value of the institution's residential mortgage assets, and the book value of such mortgages sold in any one fiscal year shall not exceed five percent of the total book value of the institution's residential mortgage assets;

(3) All of the proceeds of such sales shall be reinvested in residential mortgage loans within 90 days;

(4) The authority granted by this paragraph (d) shall not be used to reduce the institution's statutory reserve to less than three percent;

(5) The exemption shall be effective for no more than five years from the date of the sale in connection with which the exemption is granted;

(6) The institution establishes and maintains a plan setting forth (i) that all of the conditions set out above shall be met; (ii) the benefits, including cash-flow benefits, the institution expects to gain from the exemption; (iii) the institution's plan for building up its statutory reserve to the minimum amount required by paragraph (a)(2) of this section and its net worth to the minimum amount required by paragraph (b)(2) of this section within five years of the date of the sale in connection with which the exemption is granted; and (iv) a summary of any prior sales made pursuant to this paragraph; and

(7) The institution shall maintain complete records of all transactions undertaken pursuant to this paragraph.

In no event shall any sale made under the provisions of this paragraph (d) occur after December 31, 1982.

(Sec. 409, 94 Stat. 160. Secs. 402, 403, 407, 48 Stat. 1256, 1257, 1260, as amended (12 U.S.C. 1725, 1726, 1730). Sec. 5A, 47 Stat. 727, as amended by Sec. 1, 64 Stat. 256, as amended, sec. 17, 47 Stat. 736, as amended (12 U.S.C. 1425a, 1437). sec. 5, 48 Stat. 132, as amended (12 U.S.C. 1464). Reorg. Plan No. 3 of 1947, 12 FR 4891, 3 CFR, 1943–48 Comp., p. 1071)

By the Federal Home Loan Bank Board.

Robert D. Linder,

Acting Secretary.

[FR Doc. 80-36004 Filed 11-17-80; 8:45 am]

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DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

18 CFR Parts 4 and 375

[Docket No. RM80-65; Order No. 106]

Exemption From All or Part of Part I of the Federal Power Act of Small Hydroelectric Power Projects With an Installed Capacity of Five Megawatts or Less

Issued: November 7, 1980.

AGENCY: Federal Energy Regulatory Commission.

ACTION: Final rule.

SUMMARY: The Federal Energy Regulatory Commission adopts procedures to exempt from all or some of the requirements of Part I of the Federal Power Act, including licensing, small hydroelectric power projects with a proposed installed capacity of 5 megawatts or less. The final rule constitutes a means of evaluating such projects for exemption on a case-by-case basis and is the first action undertaken to implement section 408 of the Energy Security Act of 1980. The statute also gives the Commission discretion to exempt classes or categories of small hydroelectric power projects.

Only projects with a generating capacity of 5 megawatts or less, including new capacity that must be developed in order to qualify a project for exemption, may be exempted. These projects must utilize the water power potential of an existing dam or a natural water feature, without the need for a dam or impoundment. The rule sets forth who may apply for exemption, how to apply, and how any conflicts between an exemption application and any other kind of application to develop a project will be resolved.

The final rule is designed to encourage the development of small hydropower facilities by providing a method of relieving them from certain regulatory requirements.

EFFECTIVE DATE: November 7, 1980.

FOR FURTHER INFORMATION CONTACT:

Ronald A. Corso, Director, Division of Hydropower Licensing, Office of Electric Power Regulation, 825 North Capitol Street, NE., Washington, D.C. 20426, (202) 357-3507/5321;

Howard A. Jack, Assistant General Counsel for Hydroelectric Licensing, Office of the General Counsel, 825 North Capitol Street, NE., Washington, D.C. 20426, (202) 357-8448;

James H. Hoecker, Division of Regulatory Development, Office of the General Counsel, 825 North Capitol Street, NE., Washington, D.C. 20426, (202) 357-9342.

The Federal Energy Regulatory Commission (Commission) establishes procedures for exempting from all or part of Part I of the Federal Power Act (Act) certain small hydroelectric power projects (projects) having a proposed installed generating capacity of 5 megawatts or less. The rule implements in part section 408 of the Energy Security Act of 1980 (ESA).[1] The Commission will provide such exemptions based on case-by-case determinations and will consider further rulemakings to exempt classes or categories of projects, as permitted by section 408(b) of the ESA. The final rule is effective November 7, 1980.

I. Background

Title IV of the ESA, also known as the Renewable Energy Resource Act of 1980, contains a provision that amends the Public Utility Regulatory Policies Act of 1978 (PURPA) to authorize the Commission to exempt certain small hydroelectric power projects, on a case-by-case basis or by class or category of such projects, from all or part of Part I of the Act, including any licensing requirement.

Section 408 grants the Commission discretion to provide exemption under the following specified conditions. The proposed installed capacity of an exemptible project may not exceed 5 megawatts. To be exemptible, a project must utilize the water power potential of an existing dam, unless it is a project that will utilize a so-called "natural water feature" that does not require the creation of a dam or man-made impoundment. Such a natural water feature will commonly be an elevated lake or a waterway the topographical features of which permit diversion of some waters for purposes of power generation. Finally, section 408 provides that certain environmental requirements apply to those projects that the Commission exempts from licensing. Those requirements include the National Environmental Policy Act, the Fish and Wildlife Coordination Act, the

[1] Pub. Law 96-294, 94 Stat. 611. Section 408 of the ESA amends, *inter alia*, sections 405 and 408 of the Public Utility Regulatory Policies Act of 1978 (16 U.S.C. §§ 2705 and 2708).

Endangered Species Act, and the consultation provisions in section 30 of the Federal Power Act that apply to exemption of small conduit hydroelectric facilities.

The Notice of Proposed Rulemaking in this docket was issued for public comment on August 28, 1980.[2] Prior to issuing the proposed rule, the Commission issued a Notice of the Availability of a Draft Rule and of Informal Conferences.[3] Pursuant to that notice, the Commission's staff took informal comments on the draft rule and related inquiries and held informal conferences on them in Washington, D.C. on August 1, 1980 and August 12, 1980. In addition to requesting written comments on the rule as finally proposed, the Commission held a third public meeting to discuss the rule, on September 23, 1980. The comments, including transcripts of the three meetings, are available for inspection in the public files of the Commission.

This phase of the implementation of section 408 of the ESA utilizes case-by-case determinations based on information provided by individual applicants to provide exemptions for small hydroelectric power projects.[4] The Commission will exempt small hydroelectric power projects in much the same way it now exempts small conduit hydroelectric facilities.[5]

This exemption rule has several important features. First, only a person who has sufficient property interests to develop a small hydroelectric power project may apply for exemption. Second, a project owner may apply for exemption from licensing or from any of the other provisions of Part I of the Act, but application procedures for each of these two kinds of exemption differ. Third, all, but not part, of a currently licensed water power project is exemptible. Fourth, the rule explains in detail a system of priorities and preferences among the various kinds of applicants that seek to develop a project. Finally, an applicant may seek, consistent with the statute, waiver of any provision of the rule.

II. Comment Analysis

Two related issues received the most extensive commentary. The proposed rule permitted only a project owner, *i.e.*, someone with a real property interest sufficient to develop the project, to apply for exemption and provided that exemption applications timely filed will be preferred to applications for preliminary permit or, all other things being equal, for license. The proposed rule, had the effect of eliminating the preference that section 7(a) of the Act would afford a non-owner state or municipality that applies for a license or preliminary permit insofar as such applicant competes with an accepted application for exemption. Instead, the proposed rule provided project owners a priority over non-owners, regardless of state or municipal status.

Municipalities and associations of local public power systems oppose both the proposed abandonment of the statutory municipal/State preference in relation to the exemption process and the preference given to exemption applicants over non-owner license or permit applicants. The public power entities argue that States and municipalities that are not project owners are entitled to preferential treatment under the Act when competing with exemption applicants for the right to develop a site. They contend that in providing the Commission with the power to exempt certain projects from the Act, the Congress intended only to cut the red tape that accompanies licensing, not to establish a new system of priorities or preferences. These commenters assert that the preference is a controlling factor in dealing with any water power project within the Commission's jurisdiction, whether in an exemption context or not, and is not a licensing requirement from which a project may be exempted under section 408 of the ESA. They argue for the primacy of the licensing over the exemption process based on the safeguards they allege the former process to provide for the public interest. Licensing is to be supplemented by the exemption process, they say, only to the extent that licensing fails to encourage the development of a project. Based on this presumption, the American Public Power Association (APPA) proposes a procedure wherein any competition arising before the Commission between exemption applicants and license or permit applicants would convert the process to one for a permit or a license, with the municipal and State preferential rights under section 7(a).

The approach reflected in the proposed rule is supported by most of the private hydropower developers and investor-owned utilities. They claim that the statutory preference, as well as the threat of condemnation by a successful State or municipal licensee under section 21 of the Act, deters private developers from even identifying a site by applying for a permit or license. If the preference system were invoked under the proposed exemption rule, these commenters contend that it would also deter exemption applicants. The Congress did not prohibit the Commission from providing exemption from section 7(a) of the Act when it granted the Commission discretion to exempt projects "in whole or in part from the requirements (including the licensing requirements) of Part I" of the Act. One commenter cited changes in economic circumstances since the enactment of the preference as a basis for eliminating the preference, at least from the exemption process.

The Commission agrees that the legislative history of section 408 of the ESA does not address this issue; the statute is clear on its face, however. The Commission may choose to exempt any or all projects under 5 megawatts from the provisions of section 7(a) or any other requirement of Part I of the Act. Thus, the Commission may regard as equals all applicants that seek to develop a small hydroelectric power project, within the context of the exemption process, without regard to whether they are governmental entities or not. There are several important reasons for doing so. Moreover, when competitors are otherwise equal, there are good reasons for generally preferring the project owner.

The exemption authority was provided by the Congress to encourage small hydropower development. This will occur as a result of removing regulatory impediments where possible and by allowing market forces relatively free reign consistent with that purpose. In light of this objective, the Commission believes the national interest in encouraging development of a small renewable energy resource project with new or added capacity is more important than Federal Government control of who actually does it or who gains the immediate economic benefit.

APPA argues that, where competition for a site exists, an exemption is unnecessary; the exemption process is intended to encourage development of previously ignores sites, not necessarily or primarily to expedite development of known and usable sites. The Commission believes APPA's position misses several significant points. First, unless those persons with first-hand knowledge about available sites, frequently project owners, are encouraged to come forward with plans for development, the question of

[2] 45 Fed. Reg. 58368, September 3, 1980.

[3] 45 Fed. Reg. 49591, July 25, 1980.

[4] The Commission's staff is currently developing further rulemakings to implement the provision in section 408(b) of the ESA allowing the Commission to exempt "classes or categories" of projects, thereby obviating any application procedure.

[5] *See*, Order No. 76, 45 Fed. Reg. 28085, April 19, 1980.

competition will never arise with respect to much currently unexploited hydropower potential. Few non-public project owners will venture to formulate development plans and apply for exemption, if they would thereby expose their projects to taking facilitated by the municipal/State preference. Moreover, even where hydropower sites are known to be available for further development, speed of development would likely be sacrificed by undertaking a comparison of the relative merits of the applications submitted by public and private developers and by the inevitable conversion, under the APPA proposal, to a licensing proceeding at any time that a public entity that is not the project owner filed a competing application. Many years or experience in administering the Act show that cases involving competing applications take significantly longer to decide and demand more time and money from the perspective of developers. Thus, encouraging States and municipalities to file competing applications increases the institutional barriers to rapid hydropower development.

Other considerations support the Commission's decision not to apply section 7(a) to the exemption process. The procedures in the proposed and final rules do not prevent a state or municipality from developing a site. A non-owner public entity will be in at least as good a position as any other non-owner; it may still negotiate with the project owner for access to the project, whether by sale, lease, or other available contractual device. In other words, a state or municipality may do business like anyone else in order to obtain an interest sufficient to develop the site.[6] If that fails, the alternative of a condemnation proceeding under the state laws governing eminent domain is often available. A state or municipality that obtains the necessary property rights by purchase or condemnation may then obtain an exemption as the project owner. Or, as APPA itself pointed out, the state or municipality may often be able to condemn an exempted project under state law after it has been exempted. In fact, APPA acknowledged that the primary benefit of retaining the preference under section 7(a) would be that the state or municipal licensee would suffer less adverse political reaction by condemning a project under Federal law, as a licensee, than under state law.

Project owners, public or private, should be able to go forward expeditiously to develop small projects. The operation of a statutory preference should not be allowed to encourage competing applications by non-owners and infuse uncertainty into the development of small hydroelectric power plants and thereby defeat Congressional objectives. The Commission can most effectively use its authority under section 408 of the ESA by dealing only with persons that have the requisite property interests to bring new capacity on line as soon as possible.

Some commenters oppose the preference given project owners under the proposed rule. The proposed rule provided, under § 4.103, that exemption applications filed by project owners would be preferred to permit or license applications, if filed within the public notice period prescribed for the permit application, with some exceptions. Opponents point out that the statute says nothing about project owners, that non-owner private or public developers will be reluctant to file for a permit or license in light of the preference for exemption applicants, that some project owners may seek just to block development, and that speculation in hydropower sites may result from a rule that puts a premium on project ownership.

First, the Commission anticipates that, because of the project owner preference, in a few instances persons who are not project owners may indeed be dissuaded from applying for licenses or permits for projects which are recognized as ripe for further development. In most instances, however, the absence of an automatic preference for public developers, the lower likelihood of competition, the prospect of an exemption from licensing, and the new economic attractiveness of hydropower will be strong incentives for a previously reluctant owner to apply to develop a project. The more attractive development is economically, the more likely it is that market forces will lead a project owner to develop a project or a non-owner to make an offer that will induce the current owner to sell sufficient rights to render the non-owner an owner. Moreover, the exemption authority in the ESA is founded upon the presumption that more capacity will be developed sooner by means of exemption than by license. Therefore, in the interest of expeditious development, it makes sense not only to favor exemption applications over those for permits or licenses, but also generally to favor that class of persons more immediately capable of capitalizing on exemptions by undertaking to add or rehabilitate generating capacity—those who already own sufficient property interests.

It is important to note that, although project owners are in a more "favored" position than normally under the Act—in that they are subject only to market pressures and not to artificially created regulatory pressures—the final rule does not isolate the owner entirely from regulatory pressures. The final rule clarifies that a project owner will not obtain an exemption where a non-owner who was also a preliminary permittee has made timely application for a license. In addition, however, it provides that where a non-owner license applicant has filed first, the Commission will favor that application unless the plans of the subsequent exemption applicant would better develop the water power potential of the project. The final rule also allows a non-owner to file for a license after the exemption application, if it proposes a plan of power development that would render the project significantly better than any exemptible project.

The hierarchy of application preferences in § 4.104 balances the public interest in expeditious development under an exemption with some opportunity for non-owners to compete and propose more comprehensive development of a site. A permit application reflects an intent by the applicant only to study a site for development. A license application manifests both the plans and the capability for imminent development. Because exemption applications for projects 5 megawatts and less will be similar in content and imminence of development to license applications, they will be preferred to permit applications, just as license applications are preferred to permit applications (*see* § 4.33). Similarly, because the exemption applicant must be a person with sufficient real property interests in any non-Federal lands involved to develop a site immediately, the rule provides such applicants with advantages over license applicants who have no such property interests. For example, a first-filed exemption application will bar any license application, with the one limited exception noted above. Favoring a project owner will also tend to reduce the costs of litigation associated with competition for a power site and the transaction costs of transferring the project involuntarily from the owner to some other developer.

[6] The Commission also notes that this rule gives a state or municipality that is a project owner protections and preference against other interested states or municipalities that are non-owners, who might otherwise get a license for the project and condemn it under the Federal power of eminent domain.

One commenter advocated that no exemption application should be considered by the Commission if there is a previously filed license application. This approach was originally set forth in the draft rule. If a project owner failed to seek a permit or an exemption or license to develop a site, the price of that failure would be to risk loss of the site to a non-owner who first proposed development in a permit or license application. While this approach itself has not been adopted, the Commission recognizes that there is a problem. The Commission believes that the rule should not discourage interested non-owners who wish to exploit the full water power potential of a site in circumstances where the project owner does not take timely action to protect itself and develop the site adequately. Therefore, under § 4.104 the protection afforded the project owner has been restricted as follows: a project owner may not file for exemption for a project for which there is a preliminary permittee that files a timely application for license, *i.e.*, before the permit expires; even where there has been no permit, a non-owner license applicant will be preferred to an exemption applicant that files second and in competition with the license applicant, unless the plans of the exemption applicant would better develop the water power potential of the affected water resources; and a non-owner may file for a license in competition with an accepted exemption application, if the non-owner proposes significantly better power development that would make the project ineligible for exemption, *i.e.*, at least 7.5 megawatts, or 50% more capacity than the maximum allowed under the statute.

One commenter suggested that exemptions be limited to a term of 30 years. The final rule does not limit the term of exemptions; the Commission has chosen to grant exemptions in perpetuity, subject to standard conditions. A project with only a 30-year exemption would be virtually a licensed project by another name. The only considerations that would warrant reexamination of whether to continue the exemption for a project after a term of years are more appropriate for licensed projects or are, like the possibility of more comprehensive development, provided for under the scheme of exemption.

It was proposed that a project owner be given the latitude to apply for an exemption at any time up to final Commission action on a pending license or permit application or to convert a license application to an exemption application at any time before the license application is approved. The proposals have been rejected because they pose unreasonable burdens upon efficient administration of the permit, license, and exemption programs. To provide some certainty to the Commission, its staff, and other interested agencies and persons and to allow expeditious completion of proceedings, the nature of the proceeding and the participant must be fixed at a relatively early point. Therefore, the project owner is afforded only a limited time either to file in competition with a non-owner's application for a license or permit or to request that a license application be treated as one for exemption.

Numerous commenters opposed the exclusion of projects located on Federal lands from this case-by-case exemption process. The failure to include such projects was described as especially burdensome on project owners in the western United States, where a large portion of all land is Federally-owned and a high probability exists that a project will involve Federal land in some way, even if the dam and powerhouse, for example, are located on private property. Some commenters proposed deletion of the reference to Federal lands in the definition of "small hydroelectric power project," leaving project owners to negotiate access to Federal lands within one year. If rights to use public lands were not obtained, the procedure could then be changed to a licensing procedure. It was also suggested that the rule should exempt projects with only transmission lines on Federal lands or that any project on Federal lands leased for power purposes be made exemptible.

The Commission acknowledges the difficulty facing western developers with respect to this issue under the proposed rule. The Commission's concern is both to protect lands in the public domain and to permit development of projects that depend on such lands for power generation or distribution. In light of the comments, the Commission has lifted the proposed restriction relating to projects on Federal lands. The reference to Federal lands has been removed from the definition of "small hydroelectric power project." Projects that use Federal lands may therefore be exempted from any portion of Part I of the Act, subject to the new standard condition in Article 5 [§ 4.106(e)], which states that an exemption from licensing in no way confers any right to use or occupy Federal lands. Such rights must be obtained from the appropriate Federal land management agency. If the right to use any Federal lands involved is not obtained for the project within one year, the Commission may accept a license application for the project from any person to whom it is authorized to issue licenses under section 4(e) of the Act, and may revoke the exemption.

Although there was general approval for the Commission's decision not to use the broad definition of "project" in the Federal Power Act in establishing the scope of an exemptible facility, it was further suggested that, for purposes of exemption, a "project" be defined as an individual generation site, presumably the power-plant and appurtenant facilities. This would, of course, have the effect of preventing aggregation of the capacity of more than one powerhouse that uses water from the same impoundment for purposes of determining whether a project is within the 5 megawatt limitation. In those few cases where several small, independent power generating sites depend on a single impoundment, whether or not under license, a narrower definition would probably optimize the developmental impact of the exemption process. However, there are various practical difficulties in defining "project" solely in terms of a generation facility, without, among other things, encouraging applications that might attempt to circumvent the 5 megawatt statutory limitation; or failing to include the dam and impoundment in either an exempted project or a licensed project where the Commission could impose conditions on their use and maintenance—for environmental or dam safety reasons, for example. The Commission nevertheless recognizes the value, in some circumstances, of exempting certain sites that clearly are separate and distinct from other generating sites at the same dam and impoundment and has provided an opportunity for applicants to obtain waiver of the provisions that necessitate aggregation of all capacity at a single impoundment.

The definition of "small hydroelectric power project" includes run-of-river projects, a concern of two commenters. The 5 megawatt capacity limitation will not be applied only to capacity *added* to a project, as requested by another commenter. Such application of this statutory limitation would permit exemption of large projects based on a comparatively insignificant addition to capacity. That could be an unfortunate result from an environmental or safety perspective. It appears from the language of Title IV of PURPA, as amended by § 408 of the ESA, that

Congress intended to give the Commission authority to exempt small hydroelectric projects, as a whole, not small increments of capacity at large hydroelectric projects. In response to a related comment, the installation or increase in capacity that is required for a project to qualify for exemption does include replacement or rehabilitation of old capacity as well as adding increments of new capacity, so long as the project owner is proposing to develop capacity that was not previously being used. Although this was explained in the preamble to the proposed rule, a new definition of "install or increase" clarifies this position.

The proposed rule excluded from exemption any project that is part of a licensed project with more than one development or impoundment. Insofar as the licensing and relicensing of projects is concerned, the exemption from licensing of small portions of these larger projects will frequently produce some confusing results, such as how to apply and coordinate license and exemption conditions, especially in light of the limitation on license term and the possibility of competition for a new license. The Commission believes that a licensee may often be able to amend its license to accommodate the addition of a small generation facility with about the same filing obligations and waiting time as provided under the exemption process.[7] Two changes in the rule have evolved from consideration of this issue, however. First, the Commission will not accept an application for exemption from licensing of only a part of any licensed project. The entire licensed project may be exempted, if it is eligible for exemption under the rule. This limitation may of course be waived under § 4.103(d), if consistent with the statute in a particular case. Secondly, if a person applies for exemption from provisions other than licensing, that application should occur in relation to a license application or application for amendment of license. The rule therefore treats such applications differently from applications for exemption from licensing. Procedurally, they will be handled within the context of the licensing process. In addition, the form and content of the application will be significantly different, and much simpler, under § 4.108.

Commenters addressed various issues relating to project ownership and the question of who may apply for exemption. The argument made by some commenters (discussed above) that license applicants should be preferred to, or given consideration equal to, exemption applicants is offered in conjunction with a request that project owners not be preferred to non-owners, based on the fact that an exemption is arguably a special type of license to develop a project. Based on this assumption (which is incorrect, given the differences between license and exemption procedures, conditions, privileges, and responsibilities), it is argued that persons other than project owners should be able to obtain exemptions and that not to permit this will lead to the speculative acquisition of power sites.

The Commission continues to believe that of granting exemptions to persons who lack the requisite property interest to develop the site is generally likely to lead to confusion over the right of owners and non-owner exemption applicants. Moreover, an exemption is of little use to a non-owner, especially if the project owner is already a licensee or license applicant that seeks to develop the project under a different series of conditions and responsibilities. Any speculative activity that arises as a result of the value which the final rule places on project ownership ought to be regarded as an expected result of free market activity. If speculation is not accompanied by actual development of a site, the exemption may be revoked by the Commission under Article 3 which, as amended from the proposed rule, would also prevent the site from being exemptible for the following two years, thereby diminishing the economic attractiveness of being the project owner and failing to develop the project.

In conjunction with the modification of the proposed rule to accommodate Federal lands, the definition of "project owner" has been eliminated. the same concept appears in § 4.103(b), however, for circumstances involving all non-Federal lands or a mix of Federal and non-Federal. Where a project involves only Federal lands, there is no "project owner" of non-Federal lands affected, and thus the final rule allows any person to file for exemption of that kind of project.

In a related matter, the rule has also been revised with respect to who may apply for a license after an exemption is granted. As proposed, if the real property interests in non-federal lands necessary for development were split among two or more persons, only the combination of owners could apply for a license for the project in the first instance. In instances like changes in a joint venture that obtained exemption (such as an acrimonious falling out of partners) or splitting of unitary property interests to disparate persons (such as, through death and distribution), the proposed rule might have created an undue barrier to expeditious development. Thus, the final rule allows any person with any necessary real property interest in the non-Federal lands involved to apply for a license after an exemption has been granted. One commenter requested that a project owner who acquires a project after a license application is filed should be permitted to apply for exemption. If the new owner is not a former permittee and the public notice period has not expired, he may apply for exemption. If the former owner has already applied for exemption, that application may be amended to reflect the new owner as the applicant, just as permit or license applications are sometimes amended under § 1.11 of the Commission's regulations.

The question is raised about how conflicting claims of sufficient property rights would be resolved. The application for exemption from licensing requires evidence of ownership for that purpose. There is nothing unusual about the nature of such rights in the case of exemptions; they will range from fee title to rights-of-way to options to buy.[8] The proposed and final rules give examples of what constitutes project ownership. If there were no Federal licensing at all, the same ownership interests would have to be perfected to develop a site. Of course, a fee owner and a person with an option to buy would each qualify to file for exemption before the option is exercised. However, since the exemption attaches to the project and not the owner, any conflict that arose between the two would be left for private resolution, subject to the conditions of the exemption. But, a mistake about the sufficiency of an exemption applicant's property interests will not invalidate an exemption that has been granted. In addition, the problems that a project owner may face with respect to other kinds of regulatory

[7] The Commission will consider a rulemaking designed to extend most of the advantages of short-form license applications to all water power projects at existing dams with a total capacity of 5 megawatts or less. This would also be the form used to amend an existing license to include a facility of this size. The Commission has in the past completely processed such license amendments in as little as 3 months.

[8] Possession of state power of eminent domain is not an adequate substitute for ownership of non-Federal lands. The possibilities of bitter and lengthy condemnation litigation before development could go ahead and the 18-month limit on commencing construction portend too great a risk that exemptions in such circumstances would be wasted proceedings. An entity with state power of eminent domain may, of course, take the necessary interests and then apply for exemption.

approvals must be resolved outside the exemption process.

Article 2, in § 4.106(b), requires compliance with any conditions prescribed by fish and wildlife agencies. Commenters claim that this is a forfeiture of Commission responsibilities which will deter exemption applications. they request that the Commission prescribes lenient environmental conditions where appropriate or possible, eliminate Article 2 where state licensing procedures exist, or at least urge other agencies to make conditions minimal. Section 408 of the ESA, which incorporates part of section 30 of the Act, gives fish and wildlife agencies authority to establish binding exemption conditions for carrying out the purposes of the Fish and Wildlife Coordination Act. The Commission will not interpret the statute otherwise. However, it is for the Commission to insert the recommendations of those other agencies as conditions of an exemption. In order to provide a project owner with fair notice of the conditions imposed on the exempted project and to administer the exemption process efficiently, Article 2 requires compliance with fish and wildlife agency conditions that have been included with the applicant's Exhibit E or submitted directly by the agency within the time provided for comment.

One state agency posed several questions about environmental matters. A state need not intervene to participate in the environmental consultation process prescribed in Exhibit E. An applicant must supply evidence of the consultation which it must undertake with appropriate state and Federal agencies or the application will be considered patently deficient and rejected. In response to the request for a definition of critical habitat, the Commission notes that the U.S. Fish and Wildlife Service establishes and publishes a list of critical habitats in its regulations. Finally, the Commission will, as requested, provide a list of fish and wildlife agencies on request. Such a listing would be too cumbersome to include in the rule.

Two commenters argue that projects at "existing dams" include those at breached dams, no matter how badly breached a dam may be, and that the Commission should clarify this in the rule. Such projects should be made exemptible if the project owner proposes to reconstruct the dam, they say. The commenters point to section 408(a)(6) of PURPA which defines "existing dam" for purposes of small hydroelectric power projects as "any dam, construction of which was completed on or before April 20, 1977, and which does not require any construction or enlargement of impoundment structures (other than repairs or *reconstruction*) * * *." (Emphasis added.) One commenter states that the Department of Energy, in granting PURPA loans, considers this to have the effect of including among existing dams even badly breached dams. It is not clear that a dam so badly breached that nothing remains but abutments is an "existing dam." Section 408 (a)(1) of PURPA defines a small hydroelectric power project as one located "at the site of an existing dam", and this definition limits the scope of our authority to grant exemptions. The explanatory statement of the Conference Committee which accompanied the original Title IV of PURPA states that "the phrase 'at the site of an existing dam' should be strictly construed to mean at the site of an existing impoundment."[9] Badly breached dams will have no impoundment and an argument may be made that such dams do not qualify for the financial assistance program under Title IV. Whether Congress intended such dams to be excluded from exemption under the 1980 amendment to PURPA is unclear.

Several comments focused on the contents of the application under proposed § 4.106, now § 4.107. One commenter argued that exemption and license applications should be the same for small projects and another stated that the exemption application was too similar to a license application with respect to the information required. The Commission has held the amount of information required of exemption applicants to the minimum necessary to discharge its responsibilities under section 408 of the ESA and to determine a project's eligibility for exemption. The application is similar to, but has fewer filing requirements than, the short-form license application which may become applicable to any project of 5 megawatts or less at an existing dam. Of course, if a license is sought under Part I of the Federal Power Act, safety, comprehensive development, environmental, and engineering considerations generally necessitate a greater volume of data. Both in terms of the input and the end result, the exemption process is far simpler than the licensing process. The Director of the Division of Hydropower Licensing or any regional engineer will supply prospective applicants with an example of a completed exemption application, on request.

It is important to note that, unlike the proposed rule, the final rule provides two kinds of exemption applications in §§ 4.107 and 4.108. Exemptions from licensing will require submittal of data on a project's location, its structural and operational features, and its environmental impact. Exemption from provisions other than licensing require only identification of those provisions.

It was suggested that older dams be exempted from the requirements of Exhibit G to supply drawings of the project, because original drawings may no longer be available. The Commission will insist on such drawings, even if they have to be prepared anew, because they are essential to Commission evaluation of the projects's structural integrity.

If the developer varies its project design somewhat from that described in Exhibit A, the Commission will not revoke the exemption, as one commenter feared. Exhibit A is not submitted in order for the Commission to approve the design. As long as there is no new impoundment, capacity in excess of 5 megawatts, or radical change in construction that suggests a lack of good faith, the Commission will not be concerned, unless dam safety considerations make exemption from regulation otherwise unreasonable.

The Environmental Protection Agency (EPA) requests that Exhibit E contain analysis of flows downstream from any diversion structure and a request for state certification under section 401 of the Clean Air Act. Exhibit E now contains sufficient water resource data and analysis for interested agencies to evaluate the application. In addition, if no license is issued, there is no applicable section 401 requirement.

Some commenters claim that Article 3 did not allow an applicant sufficient time to begin construction, because of probable delays in power market negotiations, state approvals, consultation, and feasibility studies. The Commission has extended this time provision to 18 months to accommodate such potential difficulties. However, further extension would be contrary to the general purpose of the exemption process. The applicant must anticipate and solve these problems independently either before or during the time that it is seeking exemption, if necessary. In any case, revocation is not automatic under any term or condition of the rule. It should be pointed out that feasibility studies, delays from which concerned the Department of Energy, should not occur after the grant of an exemption, but are best performed before that time. An exemption application is, as noted

[9] H. R. Rep. No. 95-1750, 95th Cong., 2d Sess. 106 (1978).

earlier like a license application in terms of the stage of planning, investigation, and readiness to develop. The Commission will not require progress reports with respect to construction schedules because such enforcement mechanisms are more appropriate for licenses.

There are numerous miscellaneous comments to which a response would be useful.

1. EPA requests notice of any exemption application. EPA is already on a list of recipients for all permit, license, and exemption applications. EPA also requests an Exhibit E with such notice; the exhibit may be obtained from the applicant.

2. EPA argues that only projects operating in the run-of-river mode should be exempted; the Commission does not wish to prejudge the environmental impacts of projects that are not run-of-river. They will be considered on a case-by-case basis.

3. EPA advocates a standard term requiring that the instantaneous flow releases directly below the dam must equal or be greater than the seven consecutive day mean low flow within a 10 year recurrence. The Commission will entertain comments on appropriate flow released from EPA and other Federal and state agencies in individual cases under this case-by-case rule.

4. The 120-day automatic grant provision is too short to allow for proper safeguards from environmental problems, argues EPA; if an EA is required, EPA states that this time period should be suspended. The Commission expects that a satisfactory and complete environmental assessment of a project will occur within 120 days, in most cases. The statutory goal of expeditious development requires appropriately short deadlines. If necessary, the 120-day period may be suspended.

5. One commenter states that the Commission should exempt all projects 5 megawatts and less, leaving such projects to state regulation. The Commission is examining the extent to which a generic exemption should be granted, separately from this rule.

6. Although licenses for projects are transferrable from one licensee to another with Commission approval, no transfer provision is necessary for an exempted project. The exemption is for a project, not a person, and sale or other transfer of the project does not affect the exemption. No Commission approval of transfer is required. However, new project owners may wish to notify the Commission of the transfer of ownership for purposes of any later proceeding relevant to the exempted project; otherwise, any notices will only be published in the **Federal Register** and possibly a local paper and sent to the last known owner.

7. One commenter contended that no exemption application should be considered for one year after revocation of an existing exemption. This would arguably encourage development within the prescribed time by exposing the owner to a license application by a state or municipality, with preference. The Commission generally agrees, but adopts a two-year rule under standard Article 3.

8. One commenter would have the Commission dismiss an exemption application if water rights disputes arise. This would be an invitation for some parties to dispute water rights. As indicated above, any such disputes should be worked out at the state level.

9. Some commenters state the rule should address the issue of later, more comprehensive development plans and a procedure should be established to accommodate such proposals. The Commission will consider proposals to better develop the water resources of the region in a manner that may affect a previously exempted project. An exemption does not preclude later creation of another licensed project that contains, overlaps, or otherwise is mutually exclusive with an exempted project, subject to whatever compensation to property owners—including owners of the exempted project—may be necessary. The procedure to develop a waterway more comprehensively is licensing.

10. One comment indicated that an exemption can be used to circumvent the requirements and safeguards of licensing and that the Commission should ensure that an exemption applicant will significantly add to the project's capacity, recommending a 20 percent increase. The Congress intended to encourage "circumvention" of the licensing process, and imposed no prerequisite like a 20 percent increase in capacity or a showing that improvements would be uneconomical without the exemption. The Commission believes such restrictions would unduly restrict the availability of exemptions.

11. A state agency requested that much more time be allowed for the consultation process and that the rule impose a consultation fee. Since additional hydropower works to everyone's benefit, all agencies should cooperate to speed its development. The final rule does not extend the proposed deadline. Nor is a fee appropriate for performing consultations on exemption applications when no fee is required for consultations on license applications. An agency that does not believe the value to the public it serves warrants consultation on a particular case may decline to consult and comment on that case.

12. One commenter questioned whether the exemption amounted to a waiver of commission jurisdiction; another commenter quite correctly pointed out that the conditions of an exemption demonstrate that the Commission has continuing responsibility for a project, to some extent. We agree.

III. Section-by-Section Summary of the Rule

The rule applies to applications for exemptions of small hydroelectric power projects having a proposed installed generating capacity of 5 megawatts or less from all or part of Part I of the Act. A small hydroelectric power project is defined as a project that uses the water power potential of an existing dam or a natural water feature without need for a dam or man-made impoundment.

§ *4.101 Purpose.*

This rule provides case-by-case exemption procedures.

§ *4.102 Definitions.*

The proposed rule defines the term "project" more narrowly than does section (3)(11) of the Act. Neither the ESA nor PURPA defines "project". Under the final rule, a project would include only those facilities directly associated with a single man-made impoundment or a natural lake. Under section (3)(11) of the Act, a "complete unit of development" might include more than one impoundment and a series of hydraulically coordinated dams. As stated above, a project, as defined by this rule, is not exemptible from licensing requirements if it comprises only a part of any licensed project, as the term "project" is used in section (3)(11) of the Act, unless the licensee obtains waiver of this restriction under § 4.103(d). Because the definition of "project" in this rule is more circumscribed and therefore may include fewer generating units, eligibility for exemption will be greater than if "project" were construed to include all dams, impoundments, and powerhouses in a large coordinated unit of development. The scope of the definition of "project" is sufficiently broad to exclude from exemption any in a series of separately developed generation facilities that have an aggregate capacity in excess of 5 megawatts and that use the same impoundment. However, the final rule contains a waiver provision (§ 4.103(d)) that would permit individual generation facilities to be exempted if waiver were granted.

If there is no lake or impoundment, "project" is defined in the rule to include the diversion structure and the facilities associated with it. However, a diversion structure that obstructs most of a natural body of water will be considered a dam, a distinction that bears on the physical scope of a project and the probable environmental impacts.

The statutory term "proposed installed capacity" is defined in the final rule to mean that an applicant must propose to add some new generating capacity at a project in order for the project to qualify for an exemption.

The definition of "install or increase," a phrase initially used in the definition of "small hydroelectric power project," states that this capacity includes proposals to install capacity where none existed previously, to replace or rehabilitate abandoned or unused existing capacity at a project, and to add capacity where there is existing operable capacity. The proposed installed capacity will be computed as the sum of both newly-developed capacity and existing capacity and may not exceed 5 megawatts in the aggregate.

This section also defines "dam," "existing dam," "Fish and wildlife agencies," "Federal lands," "non-Federal lands", "real property interests", "person," "qualified exemption applicant," and "qualified license applicant."

§ *4.103 General provisions.*

Section 4.103 describes which projects the Commission may exempt from all or part of Part I of the Act. This section also places a limitation on exemption of portions of licensed projects. Without a waiver only an entire licensed project may be exempted, if otherwise eligible under other criteria. This section also contains a general waiver provision.

This section also states who may apply for exemptions. If only Federal lands would be used for development, anyone may apply for exemption from licensing. If any non-Federal lands would be necessary to develop and operate the project, only a person, or group of persons holding all of the real property interests necessary to develop and operate that project (such as ownership in fee, a leasehold, easement, right-of-way, or an option to obtain such interest) may apply for an exemption from licensing. This prevents a person who lacks the requisite non-Federal real property interests to develop the project from obtaining an exemption for another person's project.[7] The rule does not require that a person have such ownership interests in all of the land occupied by the entire project (*e.g.*, all of the lands for the impoundment) to be considered a qualified exemption applicant. A person need only possess interests in the project necessary to develop and operate hydroelectric power at the site.

§ *4.104 Relationships among applications, exemptions, permits, and licenses.*

This section sets forth how exemptions from licensing and applications for exemption from licensing will be treated in relation to other kinds of applications relating to development of a project and any permits or licenses. Section 4.104 of the rule sets forth a system of priorities and preferences for persons who file to develop a site. Paragraph (a) establishes rules that apply when there is an outstanding license or permit for a project or when a permit or license application has been filed before the exemption application. Paragraph (c) prescribes what happens when a project is exempted or the project owner has applied for exemption before a license or permit application is submitted.

This section protects a person other than the project owner who has already applied for a permit or license, from being defeated by a project owner's untimely application for exemption from licensing. The Commission will accept an exemption application, or a notice of intent to submit one, that competes with a pending permit or license application only if it is submitted during the protest and intervention period prescribed in the public notice for the permit or license application. But the Commission will not accept an exemption application if a preliminary permittee has made timely application for license, even if the exemption application is submitted during the public notice period. Moreover, the Commission will not accept an application for exemption from licensing if a person other than the exemption applicant then has an unexpired preliminary permit or license.

This section also protects first-filing exemption applicants who own the non-Federal lands necessary for an exempt project from later permit or license applicants that would seek to take and develop the project. If an exemption application is pending, the Commission will not accept an application for a preliminary permit; nor will it accept a license application from a person other than the exemption applicant, unless the license application proposes total installed capacity of at least 7.5 MW. An exemption applicant may file a license application, but the exemption application will be deemed withdrawn and other interested persons may compete for the license. Similarly, any person owning non-Federal real property interests necessary to permit development of an exempted project may file a license application, but will then be exposed to competition by other interested developers, including municipalities with a preference under Section 7(a) of the Act.

A license applicant that is a qualified exemption applicant may request that its application for license be first considered as an application for exemption, if its license application was the first filed for the project. Such a request may be filed at any time during the period for filing protests and petitions for intervention prescribed in the public notice for its license application. A preliminary permit applicant that is a qualified exemption applicant may submit an exemption application during the public notice period for its permit application, if its permit application was the first filed for the project.

Paragraph (e) of § 4.104 contains noteworthy provisions about Commission treatment of applications that propose to develop the same project. An exemption application submitted in competition with an application for a preliminary permit will be preferred to the permit application. However, as between license applicants and exemption applicants, the Commission will favor the first-filed application unless the plans of the subsequent applicant would better develop the water power potential at the project.

Municipalities or other public entities that are not project owners and that apply for preliminary permits or licenses that compete with exemption applications will be governed by the same rules as other applicants for permits or licenses, and will not receive the preferential treatment provided under section 7(a) of the Act.

§ *4.105 Action on exemption applications.*

Section 4.105 of the final rule contains the procedures and timing provisions for Commission action on an exemption application. If the application is for exemption from provisions other than licensing, the Commission will act in the

[7] Under Part I of the Federal Power Act and Part 4 of the Commission's regulations, a person need not have sufficient property interest to develop power at a site in order to obtain a preliminary permit or a license. However, property interests must always be perfected to develop a project.

context and according to the procedures for the related application for license or amendment of license. The procedures for exemption from licensing are provided in this section.

Once an application for exemption from licensing is submitted, the Commission will allow only 45 days for correcting deficiencies. The Commission may on its own motion, or on the motion of any party in interest, order a hearing on an application for exemption. Interested agencies will have 60 days to comment on an application. If an agency does not comment within the 60 days, that agency will be presumed to have no objection to the exemption requested. A non-responding fish or wildlife agency will be presumed to have no conditions to impose other than those specified in Exhibit E of the application. If the Commission does not act within 120 days of the notice that an application is accepted, it is automatically granted on certain standard conditions.

§ 4.106 Standard terms and conditions for exemption from licensing.

The rule specifies, in § 4.106, five standard conditions of every exemption. The installation of new capacity at the exempted project must begin within 18 months and completed within four years of the date of issuance of the exemption. Failure to begin or complete development of the project on a timely basis may lead to acceptance of license applications for the project and revocation of the exemption. These provisions are designed to prevent tying up the project site for an unreasonable time without development. Other standard conditions relate to the Commission's enforcement powers, compliance with conditions imposed by fish and wildlife agencies during the exemption process, and the navigation servitude of the United States to which all exempted projects on navigable waters remain subject. A fifth article is added to require the acquisition of rights to use any Federal lands involved from the administering Federal land management agencies within one year. If they are not obtained timely, the Commission may accept license applications for the project and revoke the exemption.

The Commission may provide further (non-standard) conditions in each exemption from licensing, based on the circumstances of the exemptible project, under § 4.105(b)(6). Among other things, Commission will be concerned about the safety of project works. For example, if a project contains a dam that is ten or more meters in height above streambed, impounds 2.5 million or more cubic feet of water, or is determined to have a high hazard potential, the Commission may require periodic inspection of the project by an independent consultant.[8]

§ 4.107 Contents of application for exemption from licensing.

The rule describes the required format and contents of the application for exemption from licensing in § 4.107. The application includes an introductory statement, which identifies the applicant and the project, as well as Exhibits A, B, E, and G. Exhibit A must include a description of the facility and the proposed mode of operation. Exhibit B is a general location map.

Exhibit E is an environmental report submitted to facilitate compliance with the National Environmental Policy Act of 1969. It also contains information to facilitate compliance with the National Historic Preservation Act, the Endangered Species Act, and the Fish and Wildlife Coordination Act.

Exhibit G is a set of drawings showing structures and equipment. These drawings will permit the Commission to review the project structures, existing and proposed, in order to understand their environmental and dam safety implications.

§ 4.108 Contents of application for exemption from provisions other than licensing.

Any applicant for exemption from selected parts of the Act other than the licensing requirements must submit a list of sections from which it seeks exemption, appended to an application for license or amendment of license.

Other amendments

The Commission also amends its regulations to delegate to the Director of the Office of Electric Power Regulation, or his designee, the limited authority to grant applications for exemptions from all or part of Part I of the Act, provided an environmental impact statement is not required, for small hydroelectric power projects or small conduit hydroelectric power projects.

IV. Effective Date

The Commission finds good cause to make this rule immediately effective.[9]

[8] These criteria are in Subpart D of the Commission's proposed Regulations Governing the Safety of Water Power Projects and Project Works, issued June 16, 1980, 45 *Fed. Reg.* 41608, June 19, 1980 (Docket No. RM80–31).

[9] Under the Federal Power Act (FPA), Commission action may take effect prior to the disposition of petitions for rehearing. (*See* § 313(c)) The Commission is of the view that the rehearing provisions contained in § 313 of the FPA apply to this rule due to the relationship of the exemption provision of PURPA to the licensing provisions of Part I of the FPA. Persons participating in this rulemaking should be aware that under § 313 of the FPA an application for rehearing is a jurisdictional prerequisite to obtaining judicial review.

The procedures established by this final rule provide the means for exemption of certain hydroelectric power projects from various statutorily imposed requirements. The rule therefore both "recognizes an exemption" and, at least potentially, "relieves a restriction." Given the determination of the Congress to encourage expeditious development of hydroelectric projects and the large numbers of preliminary permit and license applications being submitted to the Commission, an immediate effective date is in the public interest.

(Energy Security Act of 1980, Pub. L. 96–294, 94 Stat. 611; Federal Power Act, as amended, 16 U.S.C. §§ 792–828c; Public Utility Regulatory Policies Act of 1978, 16 U.S.C. §§ 2601–2645; and the Department of Energy Organization Act, 42 U.S.C. §§ 7101–7352; E.O. 12009, 3 CFR 142 (1978))

In consideration of the foregoing, the Commission amends Parts 4 and 375 of Chapter I, Title 18, Code of Federal Regulations, as set forth below, effective November 7, 1980.

By the Commission.

Kenneth F. Plumb,

Secretary.

PART 4—LICENSES, PERMITS, EXEMPTIONS, AND DETERMINATION OF PROJECT COSTS

1. Part 4 is amended in the Table of Contents by adding Subpart K to read as follows:

Subpart K—Exemption of Small Hydroelectric Power Projects of 5 Megawatts or Less

2. Part 4 is amended by adding Subpart K to read as follows:

Subpart K—Exemption of Small Hydroelectric Power Projects of 5 Megawatts or Less

§ 4.101 Purpose.

This subpart provides a procedure for obtaining exemption on a case-by-case basis from all or part of Part I of the Federal Power Act (Act), including licensing, for certain small hydroelectric power projects.

§ 4.102 Definitions.

For purposes of this subpart—

(a) "Dam" means any structure for impounding water, including any diversion structure that is designed to obstruct all or substantially all of the flow of a natural body of water.

(b) "Existing dam" means any dam, the construction of which was completed on or before April 20, 1977, and which does not require any construction or enlargement of impoundment structures (other than repairs or reconstruction) in connection with the installation of any small hydroelectric power project.

(c) "Fish and wildlife agencies" means the U.S. Fish and Wildlife Service, the National Marine Fisheries Service if anadromous or estuarine fish may be affected, and any state agency with administrative authority over fish or wildlife resources of the state or states in which the small hydroelectric power project is or will be located.

(d) "Federal lands" means any lands to which the United States holds fee title.

(e) "Non-Federal lands" means any lands other than Federal lands.

(f) "Real property interests" includes ownership in fee, right-of-way, easement, or leasehold.

(g) "Licensed water power project" means a project, as defined in section 3 (11) of the Act, that is licensed under Part I of the Act.

(h) "Project" means: (1) the impoundment and any associated dam, intake, water conveyance facility, power plant, primary transmision line, and other appurtenant facility, if a lake or similar natural impoundment or a man-made impoundment is used for power generation; or

(2) Any diversion structure other than a dam and any associated water conveyance facility, power plant, primary transmission line, and other appurtenant facility, if a natural water feature other than a lake or similar natural impoundment is used for power generation.

(i) "Person" means any individual and, as defined in section 3 of the Act, any corporation, municipality, or state.

(j) "Qualified exemption applicant" means any person who meets the requirements specified in § 4.103(b)(2) with respect to a small hydroelectric power project for which exemption from licensing is sought.

(k) "Qualified license applicant" means any person to whom the Commission may issue a license, as specified in section 4(e) of the Act.

(l) "Small hydroelectric power project" means any project in which capacity will be installed or increased after the date of application under this subpart and which will have a total installed capacity of not more than 5 megawatts and which:

(1) would utilize for electric power generation the water power potential of an existing dam that is not owned or operated by the United States or by any instrumentality of the Federal Government, including the Tennessee Valley Authority; or

(2) would utilize a natural water feature for the generation of electricity, without the need for any dam or man-made impoundment.

(m) "Install or increase" means to add new generating capacity at a site that has no existing generating units, to replace or rehabilitate an abandoned or unused existing generating unit, or to increase the generating capacity of any existing power plant by installing an additional generating unit or by rehabilitating an operable generating unit in a way that increases its rated electric power output.

§ 4.103 General provisions.

(a) *Exemptible projects.* Except as provided in paragraph (d), the Commission may exempt under this subpart any small hydroelectric power project from all or part of Part I of the Act, including licensing.

(b) *Who may apply.* (1) *Exemption from provisions other than licensing.* Any qualified license applicant or licensee seeking amendment of license may apply for exemption of the related project from provisions of Part I of the Act other than licensing.

(2) *Exemption from licensing.* (i) *Only Federal lands involved.* If only rights to use or occupy Federal lands would be necessary to develop and operate the proposed small hydroelectric power project, any person may apply for exemption of that project from licensing.

(ii) *Some non-Federal lands involved.* If real property interests in any non-Federal lands would be necessary to develop and operate the proposed small hydroelectric power project, any person who has all of the real property interests in non-Federal lands necessary to develop and operate that project, or an option to obtain those interests, may apply for exemption of that project from licensing.

(c) *Limitation for licensed water power project.* The Commission will not accept for filing an application for exemption from licensing for any project that is only part of a licensed water power project.

(d) *Waiver.* A qualified exemption applicant may petition under § 1.7 of this chapter for waiver of any specific provision of this subpart. The Commission may grant a waiver if consistent with section 408 of the Energy Security Act of 1980.

§ 4.104 Relationships among applications, exemptions, permits, and licenses.

For purposes of this subpart, the Commission will treat preliminary permit and license applications, preliminary permits, licenses, exemptions from licensing, and applications for exemption from licensing that are related to a small hydroelectric power project as follows:

(a) *Limitations on submission and acceptance of exemption applications.* (1) *Unexpired permit or license application.* If there is an unexpired preliminary permit or license in effect for a project, the Commission will accept an application for exemption of that project from licensing only if the exemption applicant is the permittee or licensee.

(2) *Pending permit or license application.* (i) *Pending permit application.* If a preliminary permit application for a project has been accepted for filing, an application for exemption of that project from licensing, or a notice of intent to submit such an application, may be submitted not later than the last date for filing protests or petitions to intervene prescribed in the public notice issued for the permit application under § 4.31(c)(2) of this chapter.

(ii) *Pending license application.* (A) *Submitted by permittee.* If an accepted license application for a project was submitted by a permittee before the permit expired, the Commission will not accept an application for exemption of that project from licensing submitted by a person other than the permittee.

(B) *Submitted by non-permittee other than qualified exemption applicant.* Except as provided in clause (A), if the first accepted license application for a project was filed by a person other than a qualified exemption applicant, an application for exemption from licensing, or a notice of intent to submit such an application, may be submitted not later than the last date for filing protests or petitions to intervene prescribed in the public notice issued for that license application under § 4.31(c)(2) of this chapter.

(C) *Submitted by qualified exemption applicant.* If the first accepted license application for a project was filed by a qualified exemption applicant, the applicant may request that its license application be treated initially as an application for exemption from licensing by so notifying the Commission in writing and, unless only rights to use or occupy Federal lands would be necessary to develop and operate the project, submitting documentary evidence showing that the applicant holds the real property interests required under § 4.103(b)(2)(ii). Such notice and documentation must be submitted not later than the last date for filing protests or petitions to intervene prescribed in the public notice issued for the license application under § 4.31(c)(2) of this chapter.

(b) *Priority of exemption applicant's earlier permit or application.* Any accepted preliminary permit or license application submitted by a person who later applies for exemption of the project from licensing under paragraph (a)(2)(i) or (ii)(C) of this section retain its validity and priority under Subpart D of this part until the preliminary permit or license application is withdrawn or the project is exempted from licensing under this subpart.

(c) *Limitations on submission and acceptance of permit or license applications.* (1) *General rule.* Except as permitted under subparagraph (2) or under § 4.106(c) or (e), the Commission will not accept a preliminary permit or license application for any small hydroelectric power project if:

(i) That project is exempt from licensing, under this subpart; or

(ii) The Commission has accepted an application for exemption of that project from licensing and the application has not yet been granted or denied.

(2) *Exceptions.* (i) If the Commission has accepted an application for exemption of a project from licensing, any qualified license applicant may submit a competing license application that proposes to develop at least 7.5 megawatts in that project, or a notice of intent to file such a license application, not later than the last date for filing protests or petitions to intervene prescribed in the public notice of the application for exemption from licensing issued under § 4.31(c)(2) of this chapter.

(ii) If a project is exempted from licensing and real property interests in any non-Federal lands would be necessary to develop and operate the project, any person who is a qualified license applicant and has any of those real property interests in non-Federal lands may submit a license application for that project.

(iii) If the Commission has accepted an application for exemption of a project from licensing and the application has not yet been granted or denied, the applicant for exemption may submit a license application for that project if it is a qualified license applicant. The pending application for exemption from licensing will be considered withdrawn as of the date that the Commission accepts the license application for filing.

(iv) If a license application submitted under paragraph (c)(2)(ii) or (iii) of this section has been accepted for filing, any qualified license applicant may submit a competing license application in accordance with § 4.33 of this part.

(d) *Requirements for notices of intent and competing applications.* (1) *Competing exemption applications and notices of intent.* (i) Any notice of intent to file an application for exemption from licensing submitted under paragraph (a)(2)(i) or (ii)(B) of this section must conform to the requirements of § 4.33(b) of this chapter.

(ii) If a notice of intent is submitted under paragraph (a)(2)(i) or (ii)(B) of this section, the application for exemption from licensing must be submitted not later than 120 days after the last date for filing protests and petitions to intervene prescribed in the public notice issued for the permit or license application under § 4.31(c)(2) of this chapter.

(iii) Any notice of intent or application for exemption from licensing submitted under paragraph (a)(2)(i) or (ii)(B) of this section must be accompanied by proof of service of a copy of the notice of intent or exemption application on the permit or license applicant.

(2) *Competing license applications and notices of intent.*

(i) Any notice of intent to file a license application submitted under paragraph (c)(2)(i) must conform to the requirements of § 4.33(b) of this chapter and specify the capacity that the applicant proposes to install in the project.

(ii) If a notice of intent is submitted under paragraph (c)(2)(i), the license application must be submitted not later than 120 days after the last date for filing protests and petitions to intervene prescribed in the public notice issued for the exemption application under § 4.31(c)(2) of this chapter.

(iii) Any notice of intent or application for license submitted under paragraph (c)(2)(i) must be accompanied by proof of service of a copy of the notice or application on the exemption applicant.

(e) *Disposition of competing applications.* (1) *Exemption v. permit.* If an accepted application for a preliminary permit and an accepted application for exemption from licensing propose to develop mutually exclusive small hydroelectric power projects, the Commission will favor the application for exemption.

(2) *Exemption v. license.* If an application for a license and an application for exemption from licensing are each accepted for filing and each propose to develop a mutually exclusive project, the Commission will favor the application first filed, unless the Commission determines the plans of the subsequent applicant would better develop the water power potential of the affected water resources.

§ 4.105 Action on exemption applications.

(a) *Exemption from provisions other than licensing.* An application for exemption of a small hydroelectric power project from provisions of Part I of the Act other than the licensing requirement will be processed and considered as part of the related application for license or amendment of license.

(b) *Exemption from licensing.* (1) *General Procedure.* An application for exemption of a small hydroelectric power project from licensing will be processed in accordance with paragraphs (c) through (g) of § 4.31 of this part, except that notice will be published only once in a daily or weekly newspaper of general circulation in each county in which the project is or will be located. The additional time that may be allowed under § 4.31(d) of this part for correcting deficiencies in an application for exemption may not exceed 45 days.

(2) *Hearing.* The Commission may order a hearing on an application for exemption from licensing either on its own motion or on the motion of any party in interest. Any hearing shall be limited to the issues prescribed by order of the Commission.

(3) *Consultation.* The Commission will circulate a notice of application for exemption from licensing to interested agencies at the time the applicant is notified that the application is accepted for filing. If a particular agency does not comment within 60 days from the date of issuance of the notice, that agency will be presumed to have no comment on or objection to the exemption requested. Any comments submitted by a fish or wildlife agency must include any specific terms or conditions that the agency has determined are necessary to prevent loss of, or damage to, fish or wildlife resources or otherwise to carry out the provisions of the Fish and Wildlife Coordination Act, except those terms or conditions that may be included in Exhibit E of the application for exemption submitted under § 4.107(e). Any fish or wildlife agency that does not comment within the 60-day period will be presumed to have determined that no terms or conditions of exemption are necessary for the above purposes, except the terms and

conditions included in Exhibit E of the exemption application.

(4) *Automatic exemption.* If the Commission has not taken one of the actions set forth in paragraph (b)(5) of this section within 120 days after notifying the applicant that its application for exemption from licensing is accepted for filing, exemption of the project, as proposed, will be deemed to be found consistent with the public interest and granted, on the standard terms and conditions set forth in § 4.106.

(5) *Affirmative action on exemption.* Within 120 days after notifying an applicant that its application for exemption from licensing is accepted for filing, the Commission may take any of these affirmative actions:

(i) Grant the exemption as requested;

(ii) Grant an exemption from provisions of Part I of the Federal Power Act (and the regulations issued under those provisions) other than those for which exemption was requested, upon finding that modification of the exemption requested is in the public interest;

(iii) Deny exemption if granting the exemption would be inconsistent with the public interest; or

(iv) Suspend the 120-day period for action under this paragraph, upon finding that additional time is necessary for gathering additional information, conducting additional proceedings, or deliberating on the issues raised by the application.

(6) *Non-standard terms and conditions.* In granting an exemption from licensing, the Commission any prescribe terms or conditions in addition to those set forth in § 4.106 in order to:

(i) Protect the quality or quantity of the related water supply;

(ii) Otherwise protect life, health, or property;

(iii) Avoid or mitigate adverse environmental impact; or

(iv) Better conserve, develop, or utilize in the public interest the water resouces of the region.

§ 4.106 Standard terms and conditions of exemption from licensing.

Any exemption from licensing granted under this subpart for a small hydroelectric power project is subject to the following standard terms and conditions:

(a) *Article 1.* The Commission reserves the right to conduct investigations under sections 4(g), 306, 307, and 311 of the Federal Power Act with respect to any acts, complaints, facts, conditions, practices, or other matters related to the construction, operation, or maintenance of the exempt project. If any term or condition of the exemption is violated, the Commission may revoke the exemption, issue a suitable order under section 4(g) of the Federal Power Act, or take appropriate action for enforcement, forfeiture, or penalties under Part III of the Federal Power Act.

(b) *Article 2.* The construction, operation, and maintenance of the exempt project must comply with any terms and conditions that any Federal or state fish and wildlife agencies have determined are appropriate to prevent loss of, or damage to, fish or wildlife resouces or otherwise to carry out the purposes of the Fish and Wildlife Coordination Act, as specified in Exhibit E of the application for exemption from licensing or in the comments submitted in response to the notice of the exemption application.

(c) *Article 3.* The Commission may accept a license application by any qualified license applicant and revoke this exemption if actual construction or development of any proposed generating facilities has not begun within 18 months, or been completed within four years, from the date on which this exemption was granted. If an exemption is revoked, the Commission will not acccept a susequent application for exemption within two years of the revocation.

(d) *Article 4.* This exemption is subject to the navigation servitude of the United States if the project is located on navigable waters of the United States.

(e) *Article 5.* This exemption does not confer any right to use or occupy any Federal lands that may be necessary for the development or operation of the project. Any right to use or occupy any Federal lands for those purposes must be obtained from the administering Federal land agencies. The Commission may accept a license application by any qualified license applicant and revoke this exemption, if any necessary right to use or occupy Federal lands for those purposes has not been obtained within one year from the date on which this exemption was granted.

§ 4.107 Contents of application for exemption from licensing.

(a) *General requirements.* (1) An application for exemption from licensing submitted under this subpart must contain the introductory statement and exhibits described in this section and, if the project structures would use or occupy any lands other than Federal lands, an appendix containing documentary evidence showing that the applicant has the real property interests required under § 4.103(b)(2)(ii) of this subpart. An application for exemption from licensing must conform to the requirements set forth in §§ 1.5 and 1.14 through 1.17 of this chapter.

(2) An original and fourteen copies of the exemption application must be submitted to the Secretary of the Commission, and a copy must be served at the same time on the Commission's regional engineer for the region in which the project is located and on each of the consulted fish and wildlife agencies. Full-sized prints of all required maps and drawings must be filed with the application. Maps and drawings need not conform to the requirements of § 4.32 of this part, but must be of sufficient size, scale, and quality to permit easy reading and understanding. The Commission will request original drawings (microfilm) when it notifies the applicant that the application is accepted.

(b) *Introductory statement.* The application must include an introductory statement that conforms to the following format:

Before the Federal Energy Regulatory Commission

Application for Exemption of Small Hydroelectric Power Project From Licensing

(1) [Name of applicant] applies to the Federal Energy Regulatory Commission for an exemption for [name of project], a small hydroelectric power project that is proposed to have an installed capacity of 5 megawatts or less, from licensuing under the Federal Power Act. [If applicable: The project is currently licensed as FERC Project No. ——.]

(2) The location of the project is:

[State or territory] ——————

——————

[County] ——————

[Township or nearby town] ——————

——————

[Stream or body of water] ——————

——————

(3) The exact name and business address of each applicant are:

——————

——————

——————

(4) The exact name and business address of each person authorized to act as agent for the applicant in this application are:

——————

——————

——————

(5) [Name of applicant] is [specify, as appropriate: a citizen of the United States or other identified nation; an association of citizens of the United States or other identified nation; a municipality; a state; or a corporation incorporated under the laws of (specify the United States or the state or nation of incorporation, as appropriate)].

(c) *Exhibit A.* Exhibit A must describe the small hydroelectric power project and its proposed mode of operation. To the extent feasible, the information in this exhibit may be submitted in tabular form. The applicant must submit the following information:

(1) A brief description of any existing dam and impoundment proposed to be utilized by the small hydroelectric power project and any other existing or proposed project works and appurtenant facilities, including intake facilities, diversion structures, powerhouses, primary transmission lines, penstocks, pipelines, spillways, and other structures, and the sizes, capacities, and construction materials of those structures.

(2) The number of existing and proposed generating units at the project, including auxiliary units, the capacity of each unit, any provisions for future units, and a brief description of any plans for retirement or rehabilitation of existing generating units.

(3) The type of each hydraulic turbine of the small hydroelectric power project.

(4) A description of how the power plant is to be operated, that is, run-of-river or peaking.

(5) A graph showing a flow duration curve for the project or, if flow data are not available from United States Geological Survey records, the estimated average annual stream flow in cubic feet per second.

(6) Estimations of:

(i) the average annual generation in kilowatt-hours;

(ii) the average and design head of the power plant;

(iii) the hydraulic capacity of each turbine of the power plant (flow through the plant) in cubic feet per second;

(iv) the number of surface acres of the man-made or natural impoundment used, if any, at its normal maximum surface elevation and its net and gross storage capacities in acre-feet.

(7) The planned date for beginning and completing the proposed construction or development of generating facilities.

(8) A description of the nature and extent of any repair, reconstruction, or other modification of a dam that would occur in association with construction or development of the proposed small hydroelectric power project, including a statement of the normal maximum surface area and normal maximum surface elevation of any existing impoundment before and after construction.

(d) *Exhibit B.* Exhibit B is a general location map, which may be prepared on United States Geological Survey topographic quadrangle sheets or similar topographic maps of a state agency, enlarged, if necessary, to show clearly and legibly all of the information required by this paragraph. The map must show the following information:

(1) The location of the existing and proposed physical structures of the small hydroelectric power project, including any dam or diversion structure, reservoir or impoundment, penstocks, pipelines, power plants, access roads, transmission lines, and other important features.

(2) The relationship of the project structures to the stream or other body of water on which the project is located and to the nearest town or other permanent objects that can be readily recognized in the field.

(3) A description of who owns or otherwise has real property interests in any tract of land occupied by the small hydroelectric power project or the structures to which it is directly connected.

(e) *Exhibit E.* This exhibit is an environmental report that must include the following information, commensurate with the scope and environmental impact of the construction and operation of the small hydroelectric power project:

(1) A description of the environmental setting of the project, including vegetative cover, fish and wildlife resources, water quality and quantity, land and water uses, recreational uses, historical and archeological resources, and scenic and aesthetic resources. The report must list any endangered or threatened plant and animal species, any critical habitats, and any sites eligible for or included on the National Register of Historic Places. The applicant may obtain assistance in the preparation of this information from state natural resources agencies, the state historic preservation officer, and from local offices of Federal natural resources agencies.

(2) A description of the expected environmental impacts from the proposed construction or development and the proposed operation of the small hydroelectric power project, including any impacts from any proposed changes in the capacity and mode of operation of the project if it is already generating electric power, and an explanation of the specific measures proposed by the applicant, the agencies consulted, and others to protect and enhance environmental resources and values and to mitigate adverse impacts of the project on such resources.

(3) Letters or other documentation showing that the applicant consulted or attempted to consult with each of the relevant fish and wildlife agencies (specify each agency) before filing the application, including any terms or conditions of exemption that those agencies have determined are appropriate to prevent loss of, or damage to, fish or wildlife resources or otherwise to carry out the provisions of the Fish and Wildlife Coordination Act. If any fish or wildlife agency fails to provide the applicant with documentation of the consultation process within a reasonable time, in no case less than 30 days after documentation is requested, the applicant may submit a summary of the consultation and any determinations of the agency. Any exemption application that does not contain the information required in this subparagraph will be considered patently deficient and be rejected pursuant to § 4.31(d) of this part. The applicant may obtain a list of fish and wildlife agencies from the Director of the Division of Hydropower Licensing or any Regional Engineer.

(4) Any additional information the applicant considers important.

(f) *Exhibit G.* Exhibit G is a set of drawings showing the structures and equipment, that is, the proposed and existing project works, of the small hydroelectric power project. The drawings must include plan, elevation, and section views of the power plant, any existing dam or diversion structure, and any other principal structure of the project.

§ 4.108 Contents of application for exemption from provisions other than licensing.

An application for exemption of a small hydroelectric power project from provisions of Part I of the Act other than the licensing requirement need not be prepared according to any specific format, but must be included as an identified appendix to the related application for license or amendment of license. The application for exemption must list all sections or subsections of Part I of the Act for which exemption is requested.

PART 375—THE COMMISSION

3. Section 375.308 is amended by adding a new paragraph (11) to read as follows:

§ 375.308 Delegations to the Director of the Office of Electric Power Regulation.

The Commission authorizes the Director of the Office of Electric Power Regulation, or the Director's designee, to:

* * * * *

(11) Grant or grant with modifications, but not suspend the time for action on or deny, any uncontested application

submitted under Subparts J or K of Part 4 of this chapter for exemption from all or part of Part I of the Federal Power Act, if an environmental impact statement is not required.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 5b

[T.D. 7736]

Foreign Earned Income Exclusion and the Deduction for Excess Foreign Living Costs

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the foreign earned income exclusion and the deduction for excess foreign living costs. Changes to the applicable tax law were made by the Foreign Earned Income Act of 1978. These regulations affect U.S. citizens and residents who work overseas and provide them with the guidance needed to comply with the law.

EFFECTIVE DATE: The regulations apply to taxable years beginning after December 31, 1977.

FOR FURTHER INFORMATION CONTACT: Martha E. Kadue of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: CC:LR:T; 202-566-3289 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations under section 911 of the Internal Revenue Code of 1954 relating to the foreign earned income exclusion. The final regulations under this section are necessary to conform the regulations under section 911 to section 202 of the Foreign Earned Income Act of 1978 (Pub. L. No. 95-615, 92 Stat. 3098). This document also contains final regulations under section 913 of the Code relating to the deduction for excess foreign living costs. Section 913 was enacted by section 203 of the Foreign Earned Income Act. In addition, this document contains final regulations under sections 953, 981, 1303, 6073 and 6081 to conform the regulations to changes made by the Foreign Earned Income Act. This document does not reflect changes made to the Code by the Technical Corrections Act of 1979.

On May 9, 1979, the **Federal Register** published proposed and temporary amendments to the Income Tax Regulations (26 CFR Parts 1 and 5b) under sections 911 and 913 of the Internal Revenue Code of 1954 (44 FR 27079). A public hearing was held on August 28, 1979. On December 31, 1979, the **Federal Register** published temporary amendments to the Income Tax Regulations (26 CFR Part 5b) under section 911 of the Internal Revenue Code of 1954 (44 FR 77155). After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Explanation of Provisions

Section 911

Section 911 was amended by the Foreign Earned Income Act of 1978 to permit qualifying taxpayers who reside in a camp located in a hardship area in a foreign country to exclude annually up to $20,000 of foreign earned income. A taxpayer is not allowed a credit, however, for any foreign taxes paid or accrued on the excluded income. The regulations apply to taxable years beginning after December 31, 1978. They also apply to the taxable year beginning during 1978 of qualifying taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act to have prior law apply to that year. Prior law is section 911 as amended by section 1011 (a), (b), and (c) of the Tax Reform Act of 1976 and by section 701(u)(10) of the Revenue Act of 1978.

Section 913

Section 913, enacted by the Foreign Earned Income Act of 1978, allows to qualifying taxpayers with foreign tax homes a deduction which consists of the following amounts:

(1) A cost-of-living differential;
(2) Qualified housing expenses;
(3) Qualified schooling expenses;
(4) Qualified home leave transportation expenses; and
(5) A hardship area amount.

The section 913 deduction is a deduction from gross income and is limited to the amount of the taxpayer's foreign source earned income reduced by certain amounts. The deduction may not be claimed by a taxpayer who claims the section 911 exclusion.

Summary of Changes

Section 911

A number of revisions of the proposed regulations have been made by the final regulations, many in response to public comments. The amendments to the temporary regulations (26 CFR Part 5b) published by the **Federal Register** on December 31, 1979, are incorporated into the final regulations. Section 1.911-1(c)(1) sets forth the general definition of camp. A rule has been added, providing that two or more common areas or enclaves which house employees who work on the same project are considered to be one common area or enclave in determining whether the lodging accommodates 10 or more employees performing services at the taxpayer's worksite.

Section 1.911-1(c)(2) provides that lodging will be considered to be substandard if it is appreciably below the standard of housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of an employee of the United States who is compensated at an annual rate paid for step 1 of grade GS-14. A list of facts and circumstances to be considered in determining whether lodging is substandard is provided. In addition a list of presumptions is provided.

Section 1.911-1(c)(3) provides a new definition of remote area which focuses on the availability of satisfactory housing. A list of facts and circumstances to be considered in determining whether an area is remote is provided. In addition a list of presumptions is provided.

Section 1.911-5(a)(3) provides a new formula for determining the amount of foreign taxes to be allocated to excluded earned income when such taxes cannot be specifically allocated to the excluded earned income.

Section 913

Section 1.913-3(a) of the proposed regulations provided that the abode of a taxpayer who spends 2 consecutive months in the United States is considered to be in the United States during that 2-month period in the absence of unusual circumstances. This provision has been deleted.

Section 1.913-3(b)(2) is amended to provide that when the taxpayer's tax home is in a hardship area, then living conditions will be considered to be adverse.

The proposed regulations contained rules that disqualified the taxpayer for parts of the section 913 deduction, *e.g.*, qualified cost-of-living differential (in § 1.913-5(b)(4)), qualified housing expenses (in § 1.913-6(b)(2)), qualified schooling expenses (in § 1.913-7(b)), and qualified transportation expenses (in

§ 1.913–8(b)(3)) if the taxpayer or the taxpayer's spouse is compensated in whole or in part by an allowance excludable from gross income under section 912 for items for which a deduction would otherwise be allowed for excess foreign living costs. These rules have been altered to provide for a reduction of, rather than disqualification from, the section 913 deduction by the amount of allowances excludable from gross income under section 912 which duplicate an item for which a deduction would otherwise be allowed for excess foreign living costs.

Section 1.913–5(d)(1) of the proposed regulations has been amended by the addition of a rule providing that a dependent may be considered to share the taxpayer's abode while boarding at a school if the expenses of room and board are not deducted as a qualified schooling expense.

Section 1.913–7(b)(2) of the proposed regulations provided that only that portion of a payment attributable to the school days in the taxable year may be claimed as a qualified school expense in that taxable year. This provision has been deleted and a new rule provides that the payment attributable to school days in an academic year may be claimed as school expenses in the taxable year in which the payments were made.

Section 1.913–8(b)(1) of the proposed regulations provided a limitation for purposes of determining qualified home leave transportation expense of one trip during each 12-month period abroad. The use of the word "during" limited home leave expense to only one trip in any given 12-month period abroad. Comments noted that the statute uses the language "one trip for each 12-month period." Comments assert that circumstances such as employer requirements that no home leave be taken until after 1 year of employment, requirements of schools and the need to travel at times of the year when economy flights are available may necessitate that home leave be taken at a particular time which is within the same 12 consecutive months that another home leave has been taken. Therefore this limitation has been revised. The new limitation is one trip for each 12-month period abroad. For example, a taxpayer resident of a foreign country for two years beginning January 1, 1980, and ending December 31, 1981, could take two home leave trips in 1981 for which amounts could be taken into account as qualified home leave travel expenses providing that no home leave trip for which amounts were taken into account as qualified home leave travel expenses was taken in 1980.

Drafting Information

The principal author of this regulation is Mary E. Dean of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of Amendments to the Regulations

Accordingly, the proposed amendments of the regulations 26 CFR Part 1 are adopted with the following revisions. In addition, 26 CFR Part 5b is deleted.

Paragraph 1. Section 1.911–1 as set forth in the notice of proposed rulemaking, is amended by deleting the penultimate sentence in paragraph (b) and adding in lieu thereof two new sentences, and by revising paragraph (c). The added and revised portions are set forth below.

§ 1.911–1 Individuals qualifying for the exclusion.

* * * * *

(b) *Taxpayers qualifying.* * * * However, a taxpayer who alternates his or her abode between the camp and some other location not in a camp is not considered to reside in the camp while at the other location. As an illustration, a taxpayer who lives and works for 30 days in the camp and then lives and works for 30 days outside a camp will not be considered to reside in the camp during the 30 days while living and working outside a camp. * * *

(c) *Camp*—(1) *In general.* A camp is lodging which is all of the following:

(i) Substandard;

(ii) Provided by or on behalf of the employer for the convenience of the employer because the place where the taxpayer renders services is in a remote area where satisfactory housing is not available to the taxpayer on the open market;

(iii) Located as near as practicable to, and in the vicinity of, the worksite of the taxpayer; and

(iv) Furnished in a common area or enclave which is not available to the general public for lodging or accommodations and which normally accommodates 10 or more persons who are either employees of the taxpayer's employer or other employees performing services at the taxpayer's worksite.

For purposes of paragraph (c)(1)(ii) of this section, the term "for the convenience of the employer" has the same meaning which it has for purposes of section 119. For purposes of paragraph (c)(1)(iv) of this section, a cluster of housing units is not a common area or enclave if it is adjacent to or surrounded by substantially similar housing available to the general public. For purposes of paragraph (c)(1)(iv) of this section, two or more common areas or enclaves which house employees who work on the same project (for example, a highway project) are considered to be one common area or enclave in determining whether they normally accommodate 10 or more employees performing services at the taxpayer's worksite.

(2) *Substandard lodging*—(i) *In general.* Lodging is considered to be substandard if, under all the relevant facts and circumsances, it is appreciably below the standard of housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of an employee of the United States who is compensated at an annual rate paid for step 1 of grade GS–14. For purposes of this section, the salary of an employee is the amount required to be included in the income of the taxpayer as compensation. Relevant facts and circumstances which may indicate that lodging is substandard include (but are not limited to) the following:

(A) Inadequate living space;

(B) Lack of privacy occasioned by communal dining halls or other shared facilities;

(C) Temporary nature of the lodging, such as that inherent in prefabricated housing set in position on cinder blocks or housing consisting of movable units such as mobile homes, trailers, or portable camp facilities;

(D) An immediate environment that exposes the occupants of the housing to unsanitary or unhealthy conditions (for example, open sewers immediately adjacent to the housing) or to unusual risk of personal harm or property loss due to terrorism or civil unrest;

(E) Lack of improvements typically found in residential areas in the United States, such as paved and lighted streets, recreational areas, sewage facilities, and landscaping; or

(F) The cost per square foot of the lodging if constructed in the United States would be substantially less than the median cost per square foot to construct housing in the United States.

The general environment in which lodging is located (*e.g.*, the climate, prevalence of insects, etc.) does not of itself make lodging substandard. The general environment is relevant, however, if lodging is inadequate to protect the occupants from environmental conditions. The individual employee's income level is under no circumstances relevant to whether lodging is substandard. Thus, lodging occupied by a particular employee which is substantially inferior to the housing previously occupied by that individual in the United States is not substandard unless it is also substantially inferior to housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of a GS–14, step 1, U.S. Government employee.

(ii) *Presumptions.* Lodging will generally be considered to be substandard if it consists of any of the following:

(A) Portable, temporary, or movable housing occupied by employees who are not accompanied by spouse or dependents, in which the living space intended to be occupied by each employee is less than 250 square feet;

(B) Portable, temporary, or movable housing occupied by employees who are accompanied by spouse or dependents, in which the total interior living space intended to be occupied by a family unit is less than 800 square feet plus 200 square feet for each family member, other than the employee's spouse, who is expected to reside with the employee, and is no more than 1,200 square feet;

(C) Housing which lacks adequate and reliable heating or air conditioning if appropriate for the climate, or adequate and reliable utilities such as electricity or sewage facilities; or

(D) Housing which lacks private sleeping quarters for unrelated individuals, private bath or toilet facilities for unrelated individuals, or fresh hot and cold piped water.

Notwithstanding the fact that lodging is described in paragraph (c)(2)(ii) (A), (B), or (C), lodging will not be considered substandard if it is clearly not inferior to housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of a GS-14, step 1, U.S. Government employee. For purposes of paragraph (c)(2)(ii) (A) and (B), living space does not include shared areas, such as dining halls, lavatories, or storage facilities which are used by unrelated employees. For purposes of paragraph (c)(2)(ii) (A) and (B), housing is not portable, temporary, or movable merely because it is prefabricated.

(iii) *Determination of median salary.* In determining the median salary of American employees residing in the common area, any reasonable method may be used. For example, the median salary may be determined by taking the average of the median salaries of American employees at the beginning and end of the calendar year.

(3) *Remote area.* Solely for purposes of section 911, a remote area is a place where satisfactory housing is unavailable to the taxpayer on the open market within a reasonable commuting distance of the place at which the taxpayer renders services.

(i) *Facts and circumstances.* Facts and circumstances to be considered in determining if satisfactory housing is unavailable within a reasonable commuting distance include (but are not limited to):

(A) The inaccessibility to available housing due to geographic factors or the quality of the roads;

(B) The number of housing units available on the open market within a reasonable commuting distance in relation to the number of housing units required for the employer's employees;

(C) The cost of housing available on the open market; or

(D) Terrorism or civil unrest present in the area where housing would be available which would subject U.S. citizens to unusual risk of personal harm or property loss.

(ii) *Presumptions.* Satisfactory housing will generally be considered to be unavailable to the employee on the open market if any of the following conditions is satisfied:

(A) The foreign government requires the employer to provide housing for its employees other than housing available on the open market;

(B) An unrelated person awarding work to an employer requires that the employer's employees occupy housing specified by such person; or

(C) The place at which the employee renders services is not within a reasonable commuting distance of a community with a population of 50,000 or more individuals.

The conditions of paragraph (c)(3)(ii) (A) and (B) are not fulfilled if the requirement described therein applies primarily to American employers or employers of American employees and there is a significant number of foreign employers or employees other than Americans.

Par. 2. Section 1.911-3, as set forth in the notice of proposed rulemaking, is amended by inserting in paragraph (b)(1) after the word "each" the word "entire".

Par. 3. Section 1.911-4, as set forth in the notice of proposed rulemaking, is amended by changing paragraph (c), Examples (1), (2) and (3) as set forth below.

§ 1.911-4 Treatment of community income.

* * * * *

(c) *Illustrations.* This section is illustrated by the following examples:

Example (1). B, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year. During 1981, B receives $40,000 compensation for services performed during that year in foreign country S. C, B's spouse and a U.S. citizen, is a resident of the United States during 1981 and receives no compensation during 1981. B's salary is considered community income under the law of state X, the state of residence of both spouses. If the income were not community income, $20,000 of the $40,000 received by B would be excluded from B's gross income. As a result, whether B and C file separate returns or a joint return, the aggregate amount excluded from their combined gross income is $20,000.

Example (2). The facts are the same as in example (1), except that C also qualifies for the section 911 exclusion for the entire 1981 taxable year. * * *

Example (3). B, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year. During 1981, B receives $40,000 compensation for services performed in foreign country X during that year. C, B's spouse and a citizen of country X, and B are both residents of country X during 1981. C receives $10,000 compensation for services performed during that year in country X. Under the law of country X one-half of B's earnings (or $20,000) belong to C and one-half of C's earnings (or $5,000) belong to B. * * *

Par. 4. Section 1.911-5, as set forth in the notice of proposed rulemaking, is amended by revising paragraphs (a) and (b) as set forth below.

§ 1.911-5 Disallowance of deductions and the foreign tax credit.

(a) *Deductions.* No deduction is allowed for any expenses (other than moving expenses), losses, or other otherwise deductible items definitely related (within the meaning of § 1.861-8) in whole or in part to earned income, to the extent they are properly apportioned (under the rules of § 1.861-8) to excluded earned income. Thus, if the taxpayer earns $60,000 of qualifying earned income during the taxable year, incurs $3,000 of otherwise deductible business expenses allocable to the entire $60,000, and excludes $20,000 of that income, $1,000 of the business expenses ($3,000 × $20,000/$60,000) are not deductible, because they are apportioned to the excluded earned income of $20,000. Deductions which are not definitely related to qualifying earned income are deductible to the extent allowed by chapter 1 of the Code. Examples of deductions that are not definitely related are personal and family medical expenses, real estate taxes and mortage interest on a personal residence, charitable contributions, and deductions for personal exemptions. In the case of a taxpayer engaged in trade or business in which both personal services and capital are material income-producing factors, the deductions definitely related and properly apportioned to qualifying earned income are determined by multiplying the deductions definitely related and properly apportioned to the profits of such trade or business by a fraction, the numerator of which is qualifying earned income and the denominator of which is the profits of such trade or business.

(b) *Foreign taxes.* No deduction or credit is allowed for foreign income, war profits, or excess profits taxes paid or accrued with respect to excluded earned income. To determine the amount of disallowed taxes, multiply the tax imposed on earned income by a fraction the numerator of which is excluded earned income less deductible expenses definitely related in whole or in part to earned income, to the extent they are properly apportioned to excluded earned income (see § 1.911-5(a)), and the denominator of which is earned income less deductible expenses allocable to earned income. If the tax on earned income is imposed under foreign law on earned income and on some other amount (for example, some other type of income or an amount not subject to tax in the United States), the denominator equals the total of the amounts subject to the tax less deductible expenses allocable to all such amounts.

The following examples illustrate the determination of foreign income taxes paid or accured with respect to excluded earned income.

Example (1). A, a U.S. citizen and cash=basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year as a bona fide resident of foreign country X. For 1981, A pays $10,000 in income tax to country X. The $10,000 tax is imposed after reduction for allocable expenses and personal deductions not allocable to any particular items of income, on the following amounts: $40,000 received in 1981 for services performed during that year; and $9,000 of unrealized capital gains with respect to stock and other securities owned by A. Of the $40,000 of earned income,

$35,000 is qualifying earned income under § 1.911-2; the remaining $5,000 does not qualify for the section 911 exclusion because it is received for services performed in the United States. A incurred $4,000 of expenses which are deductible and allocable to A's earned income. A excluded $20,000 of qualifying earned income from gross income for 1981. The $9,000 of unrealized capital gains is not subject to tax in the United States. In addition to the $10,000 tax on the above amounts, A pays a separate tax to country X of $800 on $8,000 of interest received during 1981. The amount of country X tax which is properly apportioned to excluded earned income (and, therefore, not deductible or creditable) equals $4,000, which is determined by multiplying the tax of $10,000 by the following fraction:

$18,000 ($20,000 excluded earned income less $2,000 of deductible expenses allocable to excluded income)

$45,000 ($40,000 of earned income less $4,000 of deductible expenses plus $9,000 unrealized capital gains)

The separate $800 tax imposed on interest income is not apportioned in part to the excluded earned income, and the interest income is disregarded for purposes of apportioning the $10,000 tax.

Example (2). A, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year as a bona fide resident of foreign country X. In 1981, A receives $50,000 of qualifying earned income for services performed during that year and excluded $20,000 of that income from gross income. Of the $50,000 received by A, $30,000 is for services performed in country X, and $20,000 is for services performed in country Y. Country Y does not tax A's income. Country X imposes a tax of $3,000 on the $30,000 received for services in country X but does not tax A's income received for services in country Y. The $20,000 exclusion is allocated on a pro rata basis between the portion of qualifying earned income subject to tax in country X and the portion not subject to tax. Thus, $12,000 ($20,000 exclusion X $30,000/$50,000) of the $30,000 subject to tax in country X is considered excluded under section 911. The amount of country X tax which is properly apportioned to excluded earned income equals $1,200, which is determined by multiplying the tax of $3,000 by the following fraction:

$12,000 (excluded earned income subject to country X tax)

$30,000 (income subject to country X tax)

Par. 5. Section 1.913-2, as set forth in the notice of proposed rulemaking is revised by deleting from the last sentence of § 1.913-2 (a) the following phrase: "and each spouse has a different tax home which is not within a reasonable commuting distance of the other spouse's tax home."

Par. 6. Section 1.913-3, as set forth in the notice of proposed rulemaking, is revised by changing paragraphs (a), (b)(2), (e), and (f) as set forth below.

§ *1.913-3 General definitions.*

(a) *Tax home.* For purposes of section 913 and the regulations thereunder, the term "tax home" has the same meaning which it has for purposes of section 162(a)(2). An exception to the general rule is that a taxpayer shall not be considered to have a tax home in a foreign country for any period for which the taxpayer's abode is in the United States. For example, a taxpayer who lives in Detroit, Michigan, but commutes daily to work in Windsor, Ontario, would ordinarily have his or her tax home in Windsor but nevertheless would be ineligible for the deduction for excess foreign living costs. Temporary presence of the taxpayer in the United States does not necessarily mean that the taxpayer's abode is in the United States during that time.

(b) Qualified second household—

* * * * *

(2) *Adverse living conditions.* Adverse living conditions are living conditions which are dangerous, unhealthy, or otherwise adverse. If a taxpayer's tax home is in a hardship area (defined in paragraph (e) of this section), living conditions will be considered to be adverse. Adverse living conditions include a state of warfare or civil insurrection in the general area of the taxpayer's tax home. Adverse living conditions exist if the taxpayer's abode is on the business premises of the employer for the convenience of the employer and, because of the nature of the business (for example, a construction site or drilling rig), it is not feasible to provide family housing. The criteria used by the U.S. Department of State in granting a separate maintenance allowance are relevant but not determinative for purposes of determining whether a separate household is provided because of adverse living condition.

* * * * *

(e) *Hardship area.* A hardship area is any place in a foreign country (defined in paragraph (d) of this section) which is designated by the Secretary of State as a place where living conditions are extraordinarily difficult or notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925 of Title 5 of the U.S. Code to any officer or employee of the U.S. Government present at that place. Taxpayers who wish to apply for a hardship area determination must apply to the State Department Allowances Staff, Department of State, Washington, D.C. 20520.

(f) *Reasonable commuting distance.* For purposes of sections 911 and 913, a reasonable commuting distance is a distance which is capable of being traveled safely and regularly by customarily available transportation, including privately owned vehicles, in 1 hour.

Par. 7. Section 1.913-4, as set forth in the notice of proposed rulemaking, is revised by changing paragraph (a) as set forth below.

§ *1.913-4 Foreign source earned income limitation.*

(a) *In general.* The deduction allowed under section 913 may not exceed foreign source earned income reduced by the portion of definitely related deductions (within the meaning of § 1.861-8), other than the deduction allowed by section 913, that is properly apportioned to such income. For purposes of this section deductions that are not definitely related, such as personal and family medical expenses, real estate taxes, mortgage interest on a personal residence, charitable contributions, and deductions for personal exemptions do not reduce foreign source income.

* * * * *

Par. 8. Section 1.913-5, as set forth in the notice of proposed rulemaking, is changed as set forth below.

1. Paragraph (a) is revised as set forth below.
2. Paragraph (b) is revised as set forth below.
3. Paragraph (d)(1) is revised as set forth below.
4. Paragraph (e)(2) is revised by deleting the phrase "paragraph (b)(3) of this section does not apply. Thus."
5. Paragraph (e)(3) is revised as set forth below.

§ *1.913-5 Cost-of-living differential.*

(a) *In general.* The cost-of-living differential for an entire taxable year is the amount specified in tables issued annually by the Internal Revenue Service for the taxpayer's tax home and family size multiplied by the following fraction:

Number of qualifying days

Number of days in the taxable year

The amount which is the cost-of-living differential must be reduced (but not below zero) by the amount of any military or section 912 allowance excludable from gross income of the taxpayer or the taxpayer's spouse which is intended to compensate the taxpayer in whole or in part for the cost-of-living of the taxpayer's household (or of a qualified second household).

(b) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2(a) for the section 913 deduction, excluding days for which both meals and lodging are furnished to the taxpayer and the value of both is excluded from the taxpayer's gross income under section 119.

* * * * *

(d) *Family size*—(1) *In general.* In determining family size, the family includes only the taxpayer and any spouse and dependents who share the taxpayer's abode. A dependent may be considered to share the taxpayer's abode while boarding at a school only if the expenses of room and board are not deducted as qualified schooling expenses. In addition, no person is considered to share the taxpayer's abode during any days for which both meals and lodging are furnished to that person and the value of both is excluded under section 119. If family size varies during any period within the taxable year during which the taxpayer has a particular foreign tax home, a separate cost-of-living amount must be computed for each portion of that period during which the family size is different. An exception to this general rule is that a dependent who is born during a taxable year is considered to be a family member for the entire taxable year. Those amounts must then be aggregated to determine the cost-of-living differential for the taxable year.* * *

(e) *Special rules for qualified second household.* * *

(3) *Family size.* Family size is determined as provided in paragraph (d) of this section, except that the family includes only the spouse and any dependents whose abode is the qualified second household. Regardless of whether the taxpayer is actually present in the qualified second household, the taxpayer is considered a family member except during days for which both meals and lodging are furnished to the taxpayer and the value of both is excluded under section 119.

Par. 9. Section 1.913-6, as set forth in the notice of proposed rulemaking, is changed as set forth below.

1. Paragraph (a) is revised as set forth below.

2. Paragraph (b)(1) and (2) are revised as set forth below.

3. Paragraph (d)(3)(i) is revised as set forth below.

4. Paragraph (e), Example (1) is revised by deleting the word "furnishes" and inserting in its place the word "provides" and in the same sentence inserting the phrase "owned by the employer" after the word "housing" and in the same sentence inserting the word "rental" after the word "market."

5. Paragraph (e), Example (3) is revised as set forth below.

§ *1.913-6 Qualified housing expense.*

(a) *In general.* The amount of qualified housing expenses equals the reasonable housing expenses incurred by or on behalf of the taxpayer and any spouse and dependents who share the taxpayer's abode less the taxpayer's base amount. The amount of qualified housing expenses must be reduced, however, by the amount of any allowance excludable from gross income under section 912 which is intended to compensate in whole or in part for the expenses of housing located within a reasonable commuting distance of the taxpayer's tax home. Any amount required to be included in income of the taxpayer as compensation attributable to housing provided to the taxpayer shall be considered incurred on behalf of the taxpayer for housing in a foreign country.

(b) *Housing expenses*—(1) *In general.* Housing expenses include rent, utilities (other than long distance telephone charges), real and personal property insurance, occupancy taxes not described in paragraph (b)(1)(v) of this section, nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, residential parking, and repairs. Housing expenses do not include—

(i) The cost of house purchase, improvements, and other costs which are capital expenditures;

(ii) The cost of purchased furniture or accessories or domestic labor (maids, gardeners, etc.);

(iii) Amortized payments of principal with respect to an evidence of indebtedness secured by a mortgage on the taxpayer's housing;

(iv) Depreciation of housing owned by the taxpayer, or amortization or depreciation of capital improvements made to housing leased by the taxpayer, or

(v) Interest and taxes deductible under sections 163 and 164 or other amounts deductible under section 216(a).

(2) *Limitation.* Housing expenses are taken into account for purposes of this section only to the extent that they are attributable to housing for portions of the taxable year during which—

(i) The taxpayer's tax home is in a foreign country;

(ii) The value of the taxpayer's housing is not excluded under section 119; and

(iii) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction. In addition, except as provided in paragraph (d)(1) of this section relating to qualified second households, if the taxpayer maintains more than one foreign abode at the same time, housing expenses are to be taken into account only to the extent that they are incurred with respect to the abode which bears the closest relationship (not necessarily geographic) to the taxpayer's tax home.

* * * * *

(d) *Special rules for qualified second households.* * * *

(3) *Qualified housing expenses for the qualified second household*—(i) *Expenses.* In determining under paragraph (b) of this section the housing expenses relating to the qualified second household, the limitation of paragraph (b)(2)(ii) of this section does not apply, so that housing expenses may include those incurred for housing during portions of the taxable year during which the value of the taxpayer's housing at the taxpayer's tax home is excluded under section 119. In addition, the words "qualified second household" are substituted for "taxpayer's tax home" in paragraph (a) of this section. Thus, the amount of qualified housing expenses need not be reduced by the amount of any allowance excludable under section 912 for the expenses of housing located at the taxpayer's tax home, but must be reduced by the amount of any military or section 912 allowance excludable from gross income which compensates the taxpayer or the taxpayer's spouse in whole or in part for the expenses of housing at the location of the qualified second household.

* * * * *

(e) *Illustrations.* * * *

Example (3). The facts are the same as in example (1), except that there is no qualified second household, the cost-of-living differential specified in the 1980 cost-of-living table for country F (the location of B's tax home) is $3,000, and town X is located in a hardship area. The base housing amount for housing at B's tax home equals $6,000—20 percent of $30,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential, the $10,000 living expenses and the $5,000 hardship area differential). Thus, the amount of B's qualified housing expenses equals $4,000. Although B's tax home is located in a hardship area, B cannot claim as qualified housing expenses the full value of the housing provided at B's tax home, since B does not maintain a qualified second household.

Par. 10. Section 1.913-7, as set forth in the notice of proposed rulemaking, is changed as set forth below.

1. Paragraph (b) is revised as set forth below.

2. Paragraph (d) is revised by deleting the phrase "In addition, a" and inserting in its place "A" and by adding at the end three sentences as set forth below.

§ *1.913-7 Qualified school expenses.*

* * * * *

(b) *School expenses*—(1) *In general.* School expenses include tuition, fees, the cost of books, other amounts required by the school such as uniforms, and the cost of local transportation. Optional expenses, such as the cost of optional field trips or extracurricular activities, are not school expenses. If an adequate U.S.-type school is not available within a reasonable commuting distance (defined in § 1.913-3(f)) of the taxpayer's tax home, the expenses of room and board for the dependent and the cost of transportation between the school and the taxpayer's tax home at the beginning and end of the school year and during vacation periods are also school expenses. The cost of transportation includes transfer costs to and from the airport, airport taxes, exit fees or nonrefundable deposits made in order to leave the country, meals in route, and costs of involuntary stopovers in route. The cost of transportation does not include the costs of voluntary stopovers in route.

(2) *Limitation.* School expenses are qualified school expenses only to the extent that—

(i) They are not expenses for which a credit is claimed pursuant to section 44A (relating to child care) or for which a deduction is claimed pursuant to section 213 (relating to medical expenses);

(ii) They are not expenses for which the taxpayer or the taxpayer's spouse is compensated by an allowance such as the "school away from post" education allowance which is excluded from gross income under section 912;

(iii) They are attributable to education during a period in which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2 (a) for the section 913 deduction; and

(iv) They are attributable to education during a period in which the dependent resides with the taxpayer at the taxpayer's tax home or in a qualified second household.

* * * * *

(d) *Availability and adequacy.* * * * In addition, a school is not adequate if it is under religious auspices which require religious training or infuse religious training in secular courses and the taxpayer does not send the dependent to another school under the same religious auspices. A school will be considered adequate even though it does not offer enrichment programs, if such programs would not ordinarily be offered in public elementary or secondary schools in the

United States. Examples of such enrichment programs are a swimming team or orchestral training.

Par. 11. Section 1.913–8, as set forth in the notice of proposed rulemaking is changed as set forth below.

1. Paragraph (a) is revised by deleting the last sentence and adding in its place two sentences as set forth below.

2. Paragraph (b)(1) is revised as set forth below.

3. Paragraph (b)(2) is revised by deleting the phrase "lives either with the taxpayer (that is, shares the taxpayer's abode)" and by deleting the last sentence and the parenthetical "(See § 1.913–7(b)(2)(ii))."

4. Paragraph (b)(3) is revised as set forth below.

§ 1.913–8 Qualified home leave transportation expenses.

(a) *In general.* * * * Qualified transportation expenses include transfer costs to and from the airport, airport taxes, exit fees or nonrefundable deposits made in order to leave the country, meals in route, and the costs of involuntary stopovers in route. The cost of transportation does not include the costs of voluntary stopovers in route.

(b) *Limitations*—(1) *One trip for each 12-month period abroad.* Qualified transportation expenses include the cost of no more than one round trip per person for each period of 12 consecutive months (which do not overlap) during which—

(i) The taxpayer's tax home is in a foreign country; and

(ii) The taxpayer qualifies under § 1.913–2(a) for the section 913 deduction.

The trip can occur before completion of a 12-month period.

* * * * *

(3) *Double benefits denied.* Qualified transportation expense for each period of 12 consecutive months must be reduced by the amount of any allowance which is granted to the taxpayer or the taxpayer's spouse for purposes of home leave transportation at any time during that period of 12 consecutive months and which is excluded from gross income under section 912.

Par. 12. Section 1.913–9, as set forth in the notice of proposed rulemaking, is changed as set forth below.

1. Paragraph (a) is revised by adding the phrase "for an entire taxable year" after the word "amount."

2. Paragraph (b) is revised by adding at the end thereof the following sentence: "Taxpayers who wish to apply for a hardship area determination must apply to the State Department Allowances Staff, Department of State, Washington, D.C. 20520."

Par. 13. Section 1.913–10, as set forth in the notice of proposed rulemaking, is revised by deleting the word "during" the first time it appears in paragraph (e) and inserting in its place the word "for."

Par. 14. Section 1.913–13, as set forth in the notice of proposed rulemaking, is changed by deleting the third and fourth sentences.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805) and, in part, under the authority contained in section 913(m) of the Code (92 Stat. 3106; 26 U.S.C. 913(m)).

Jerome Kurtz,
Commissioner of Internal Revenue.

Approved: October 10, 1980.

Donald C. Lubick,
Assistant Secretary of the Treasury.

Paragraph 1. Sections 5b.911–1 through 5b.911–7 are deleted, and the following §§ 1.911–1 through 1.911–7 are adopted.

Sec.

§ 1.911–1 Individuals qualifying for the exclusion.

(a) *Scope.* Section 911 provides that a qualifying taxpayer may exclude from gross income qualifying earned income described in § 1.911–2. The amount that may be excluded is subject to the limitation provided in § 1.911–3. Taxpayers may make an election under § 1.911–6(a) not to claim the benefit of section 911.

(b) *Taxpayers qualifying.* A taxpayer qualifies for the exclusion provided by section 911 if the taxpayer resides in a camp located in a hardship area and satisfies either the foreign residence test or the physical presence test of § 1.913–2(a) (1) and (2). A taxpayer is considered to reside in a camp only for portions of the taxable year during which the taxpayer's abode is in a camp. A taxpayer who is away from a camp for short periods of time may still be considered to reside in the camp during those periods of absence. As an illustration, a taxpayer living in a camp who spends weekends or takes periodic vacations of short duration away from the camp may be considered to reside in the camp during those periods of absence. However, a taxpayer who alternates his or her abode between the camp and some other location not in a camp is not considered to reside in the camp while at the other location. As an illustration, a taxpayer who lives and works for 30 days in the camp and then lives and works for 30 days outside a camp will not be considered to reside in the camp during the 30 days while living and working outside a camp. An individual is not considered to reside in a camp located in a hardship area during any period when the area where the camp is located is not designated as a hardship area. (See § 1.913–3(e).)

(c) *Camp*—(1) *In general.* A camp is lodging which is all of the following:

(i) Substandard;

(ii) Provided by or on behalf of the employer for the convenience of the employer because the place where the taxpayer renders services is in a remote area where satisfactory housing is not available to the taxpayer on the open market;

(iii) Located as near as practicable to, and in the vicinity of, the worksite of the taxpayer; and

(iv) Furnished in a common area or enclave which is not available to the general public for lodging or accommodations and which normally accommodates 10 or more persons who are either employees of the taxpayer's employer or other employees performing services at the taxpayer's worksite.

For purposes of paragraph (c)(1)(ii) of this section, the term "for the convenience of the employer" has the same meaning which it has for purposes of section 119. For purposes of paragraph (c)(1)(iv) of this section, a cluster of housing units is not a common area or enclave if adjacent to or surrounded by substantially similar housing available to the general public. For purposes of paragraph (c)(1)(iv) of this section, two or more common areas or enclaves which house employees who work on the same project (for example, a highway project) are considered to be one common area or enclave in determining whether they normally accommodate 10 or more employees performing services at the taxpayer's worksite.

(2) *Substandard lodging.*—(i) *In general.* Lodging is considered to be substandard if, under all the relevant facts and circumstances, it is appreciably below the standard of housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area of the salary of an employee of the United States who is compensated at an annual rate paid for step 1 of grade GS–14. For purposes of ths section, the salary of an employee is the amount required to be included in the income of the taxpayer as compensation. Relevant facts and circumstances which may indicate that lodging is substandard include (but are not limited to) the following:

(A) Inadequate living space;

(B) Lack of privacy occasioned by communal dining halls or other shared facilities;

(C) Temporary nature of the lodging, such as that inherent in prefabricated housing set in position on cinder blocks or housing consisting of movable units such as mobile homes, trailers, or portable camp facilities;

(D) An immediate environment that exposes the occupants of the housing to unsanitary or unhealthy conditions (for example, open sewers immediately adjacent to the housing) or to unusual risk of personal harm or property loss due to terrorism or civil unrest;

(E) Lack of improvements typically found in residential areas in the United States, such as paved and lighted streets, recreational areas, sewage facilities, and landscaping; or

(F) The cost per square foot of the lodging if, constructed in the United States would be substantially less than the median cost per square foot to construct housing in the United States.

The general environment in which lodging is located (*e.g.*, the climate, prevalence of insects, etc.) does not of itself make lodging substandard. The general environment is relevant, however, if lodging is inadequate to protect the occupants from environmental conditions. The individual employee's income level is under no circumstances relevant to whether lodging is substandard. Thus, lodging occupied by a particular employee which is substantially inferior to the housing previously occupied by that individual in the United States is not substandard unless it is also substantially inferior to housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of a GS-14, step 1, U.S. Government employee.

(ii) *Presumptions.* Lodging will generally be considered to be substandard if it consists of any of the following:

(A) Portable, temporary, or movable housing occupied by employees who are not accompanied by spouse or dependents, in which the living space intended to be occupied by each employee is less than 250 square feet;

(B) Portable, temporary, or movable housing occupied by employees who are accompanied by spouse or dependents, in which the total interior living space intended to be occupied by a family unit is less than 800 square feet plus 200 square feet for each family member, other than the employee's spouse, who is expected to reside with the employee, and is no more than 1200 square feet;

(C) Housing which lacks adequate and reliable heating or air conditioning if appropriate for the climate, or adequate and reliable utilities such as electricity or sewage facilities; or

(D) Housing which lacks private sleeping quarters for unrelated individuals, private bath or toilet facilities for unrelated individuals, or fresh hot and cold piped water.

Notwithstanding the fact that lodging is described in paragraph (c)(2)(ii)(A), (B), or (C), lodging will not be considered substandard if it is clearly not inferior to housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of a GS-14, step 1, U.S. Government employee. For purposes of paragraph (c)(2)(ii)(A) and (B), living space does not include shared areas, such as dining halls, lavatories, or storage facilities which are used by unrelated employees. For purposes of paragraph (c)(2)(ii)(A) and (B), housing is not portable, temporary or movable merely because it is prefabricated.

(iii) *Determination of median salary.* In determining the median salary of American employees residing in the common area, any reasonable method may be used. For example, the median salary may be determined by taking the average of the median salaries of American employees at the beginning and end of the calendar year.

(3) *Remote area.* Solely for purposes of section 911, a remote area is a place where satisfactory housing is unavailable to the taxpayer on the open market within a reasonable commuting distance of the place at which the taxpayer renders services.

(i) *Facts and circumstances.* Facts and circumstances to be considered in determining if satisfactory housing is unavailable within a reasonable commuting distance include (but are not limited to):

(A) The inaccessibility to available housing due to geographic factors or the quality of the roads;

(B) The number of housing units available on the open market within a reasonable commuting distance in relation to the number of housing units required for the employer's employees;

(C) The cost of housing available on the open market; or

(D) Terrorism or civil unrest present in the area where housing would be available which would subject U.S. citizens to unusual risk of personal harm or property loss.

(ii) *Presumptions.* Satisfactory housing will generally be considered to be unavailable to the employee on the open market if any of the following conditions is satisfied:

(A) The foreign government requires the employer to provide housing for its employees other than housing available on the open market;

(B) An unrelated person awarding work to an employer requires that the employer's employees occupy housing specified by such person; or

(C) The place at which the employee renders services is not within a reasonable commuting distance of a community with a population of 50,000 or more individuals.

The conditions of paragraph (c)(3)(ii)(A) and (B) are not fulfilled if the requirement described therein applies primarily to American employers or employers of American employees and there is a significant number of foreign employers or employees other than Americans.

(d) *Hardship area.* A hardship area is defined in § 1913-3(e).

(e) *Section 119 and business premises.* With respect to a taxpayer who excludes income pursuant to section 911, a camp as defined in paragraph (c) of this section is considered to be part of the business premises of the taxpayer's employer for purposes of section 119 for the portion of the taxable year during which the taxpayer satisfies the foreign residence test or the physical presence test of § 1913-2(a)(1) and (2) and resides in a camp located in a hardship area.

§ 1.911-2 Qualifying earned income.

(a) *In general.* Qualifying earned income is earned income (defined in paragraph (b) of this section) which—

(1) Is attributable to services performed in a foreign country (defined in § 1.913-3(d)) during the portions of the taxable year during which the taxpayer resides in a camp located in a hardship area and satisfies the foreign residence test or the physical presence test of § 1.913-2(a) (1) and (2);

(2) Is not paid by the U.S. government or any U.S. government agency or instrumentality;

(3) Is not received as a pension or annuity or included in the taxpayer's gross income by reason of section 402(b) (relating to the taxability of a beneficiary of a nonexempt trust) or section 403(c) (relating to the taxability of a beneficiary under a nonqualified annuity or under annuities purchased by exempt organizations); and

(4) Is not received after the close of the taxable year following the taxable year in which the services giving rise to the income are performed.

For purposes of paragraph (a)(1) of this section, the place of receipt of income is immaterial in determining whether income is derived from services performed in a foreign country.

(b) *Definition of "earned income"*—(1) *In general.* "Earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered. "Earned income" does not include any portion of compensation paid by a corporation which represents a distribution of earnings and profits rather than a reasonable allowance for personal services actually rendered to the corporation.

(2) *Earned income from business in which capital is material.* In the case of a taxpayer engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer shall be considered earned income. In no case, however, may the total amount to be treated as earned income exceed 30 percent of the taxpayer's share of the net profits of the trade or business.

(3) *Earned income and employed assistants.* Earned income includes all fees received by a taxpayer engaged in a professional occupation (such as a doctor or lawyer) in the performance of professional activities. Professional fees constitute earned income even though the taxpayer employs assistants to perform part or all of the services rendered, provided the taxpayer's patients or clients look to the taxpayer as the person responsible for the services rendered.

§ 1.911-3 Determination of the maximum excludable amount of qualifying earned income.

(a) *Application of the limitation*—(1) *In general.* Qualifying earned income described in § 1.911-2 is excludable only to the extent of the limitation specified in paragraph (b) of this section for the taxable year in which the income is earned. Income is considered to be earned in the taxable year in which the services giving rise to the income are performed. Earned income is not to be attributed to any year in which the services performed are insubstantial in nature. The determination of the amount of excluded earned income in this manner does not affect the time for reporting any amounts included in gross income.

(2) *Illustrations.* Paragraph (a)(1) of this section is illustrated by the following examples:

Example (1). B, a U.S citizen and cash-basis taxpayer, is a *bona fide* resident of foreign country X for the entire taxable years 1980 and 1981. During that entire period, B resides in a camp located in a hardship area. In 1981, B receives $40,000 for services performed in country X during 1980 and 1981. Of the total amount received in 1981 ($40,000), $30,000 is attributable to services performed during 1980, and $10,000 is attributable to services performed during 1981. The limitation specified in § 1.911-3(b) is $20,000 for income earned in each of the years 1980 and 1981. Thus, $20,000 of the $30,000 earned in 1980 and the entire $10,000 earned in 1981 are excluded in 1981 (the year of receipt). The nonexcludable $10,000 of the $30,000 earned in 1980 must be included in B's gross income in 1981 (the year of receipt).

Example (2). The facts are the same as in example (1), except that in 1982 B receives an additional $5,000 for services performed in country X in 1981. Since the $10,000 of income earned and received in 1981 is excluded, the remaining limitation for income earned in 1981 which is available for earned income received in 1982 is $10,000. Accordingly, the $5,000 earned in 1981 but received in 1982 is excluded from B's gross income in 1982.

(b) *Limitation*—(1) *In general.* The limitation for each entire taxable year on the exclusion of qualifying earned income described in § 1.911-2 equals $20,000 multiplied by the following fraction:

$$\frac{\text{The number of qualifying days}}{\text{The number of days in the taxable year}}$$

(2) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the taxpayer—

(i) Resides in a camp located in a hardship area within the meaning of § 1.911-1(b); and

(ii) Satisfies the foreign residence test or the physical presence test of § 1.913-2(a) (1) and (2).

(c) *Illustrations.* This section is illustrated by the following examples:

Example (1). B, a U.S. citizen and a calendar year, cash-basis taxpayer, is a *bona fide* resident of foreign country X for the period April 1, 1979, through September 30, 1981. B resides in a camp located in a hardship area during that entire period and returns to the United States during that period only for a 3-week vacation in 1980. B receives $50,000 in each of the years 1979, 1980, and 1981 as current compensation for services performed in country X during the portions of those years during which B is a resident of country X. B receives no other compensation. The amounts of excluded income earned in taxable years 1979 through 1981 are computed as follows: of the income earned in 1979, $15,068 ($20,000 × 275/365); of the income earned in 1980, $20,000 ($20,000 × 366/366); and of the income earned in 1981, $14,959 ($20,000 × 273/365).

Example (2). B, a U.S. resident and a calendar year, cash-basis taxpayer, arrives in foreign country Y from the United States on April 24, 1980. B resides in a camp located in a hardship area during the entire time B is in country Y. B remains in country Y until October 25, 1981, at which time B departs for the United States where B remains for the rest of 1981. B qualifies under the physical presence test of § 1.913-2(a)(2) for the period during which B is in country Y. B receives $50,000 in each of the years 1980 and 1981 as current compensation for services performed in country Y during the portions of those years during which B is in country Y. B receives no other compensation. The amounts of excluded income earned in taxable years 1980 and 1981 are computed as follows: of the income earned in 1980, $13,716 ($20,000 × 251/366); and of the income earned in 1981, $16,274 ($20,000 × 297/365).

§ 1.911-4 Treatment of community income

(a) *General rule.* This paragraph applies to married taxpayers with community income other than taxpayers described in paragraph (b) of this section. The amount of excluded earned income is first determined separately for each spouse under the rules of §§ 1.911-1 through 1.911-3 on the basis of the income attributable to that spouse's services. The sum of the amounts of excluded earned income so determined for each spouse is the aggregate amount excluded on a joint return. If the couple files separate returns, one-half of the aggregate amount which would be excluded on a joint return constitutes the exclusion on the separate return of each spouse.

(b) *Special rules applicable to married taxpayers to whom section 879 applies.* The following special rules regarding the treatment of community income apply to any U.S. citizen or resident married to a nonresident alien for whom an election under section 6013 (g) or (h) is not in effect to have the nonresident alien spouse treated as a U.S. resident. Section 879 (applicable to taxable years beginning after December 31, 1976) provides that earned income of such couples which is community income under the applicable community property law is treated as the income of the spouse who rendered the services for which the earned income was paid or accrued. The amount of earned income excluded under section 911 from the gross income of the spouse who is a U.S. citizen or resident is thus computed on the basis of the earned income attributed to that spouse under section 879. Any portion of such earned income that is not excluded is taxable to that spouse. The non-resident alien spouse does not compute an excluded amount with respect to any income attributed to that spouse under section 879 since, among aother things, nonresident aliens do not qualify for the section 911 exclusion.

(c) *Illustrations.* This section is illustrated by the following examples:

Example (1). B, a U.S. citizen and a cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year.

During 1981, B receives $40,000 compensation for services performed during that year in foreign countrys. C, B's spouse and a U.S. citizen, is a resident of the United States during 1981 and receives no compensation during 1981. B's salary is considered community income under the law of state X, the state of residence of both spouses. If the income were not community income $20,000 of the $40,000 received by B would be excluded from B's gross income. As a result, whether B and C files (delete "s") separate returns or a joint return, the aggregate amount excluded from their combined gross income is $20,000.

Example (2). The facts are the same as in example (1), except that C also qualifies for the section 911 exclusion for the entire 1981 taxable year. In addition, C receives $10,000 during the 1981 taxable year for services performed in country S during that year. If all compensation received during 1981 were not community income, $20,00 of the $40,000 received by B would be excluded from B's gross income and the entire $10,000 received by C would be excluded from C's gross income. As a result, whether B and C files separate returns or a joint return, the aggregate amount excluded from their combined gross income is $30,000.

Example (3). B, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year. During 1981, B receives $40,000 compensation for services performed in foreign country X during that year. C, B's spouse and a citizen of country X, and B are both residents of country X during 1981. C receives $10,000 compensation for services performed during that year in country X. Under the law of country X, one-half of B's earnings (or $20,000) belong to C and one-half of C's earnings (or $5,000) belong to B. An election under section 6013 (g) or (h) is not in effect to have C, a nonresident alien, treated as a resident of the United States. As a result, the $40,000 income received by B is treated as the earned income of B under section 879 and is subject to U.S. tax if not otherwise excluded. The amount of earned income excluded by B from gross income is $20,000. The remaining $20,000 received by B is included in B's gross income for 1981. The $10,000 received by C is treated as the earned income of C and is not subject to tax since it is derived by a nonresident alien from sources outside the United States.

§ 1.911-5 Disallowance of deductions and the foreign tax credit.

(a) *Deductions.* No deduction is allowed for any expenses (other than moving expenses), losses, or other otherwise deductible items definitely related (within the meaning of § 1.861-8 in whole or in part to earned income, to the extent they are properly apportioned (under the rules of § 1.861-8) to excluded earned income.

Thus, if the taxpayer earns $60,000 of qualifying earned income during the taxable year, incurs $3,000 of otherwise deductible business expenses allocable to the entire $60,000, and excludes $20,000 of that income, $1,000 of the business expenses ($3,000 × $20,000/$60,000) are not deductible, because they are apportioned to the excluded earned income of $20,000. Deductions which are not definitely related to qualifying earned income are deductible to the extent allowed by chapter 1 of the Code. Examples of deductions that are not definitely related are personal and family medical expenses, real estate taxes and mortgage interest on a personal residence, charitable contributions, and deductions for personal exemptions. In the case of a taxpayer engaged in trade or business in which both personal services and capital are material income-producing factors, the deductions definitely related and properly apportioned to qualifying earned income are determined by multiplying the deductions definitely related and properly apportioned to the profits of such trade or business by a fraction, the numerator of which is qualifying earned income and the denominator of which is the profits of such trade or business.

(b) *Foreign taxes.* No deduction or credit is allowed for foreign income, war profits, or excess profits taxes paid or accrued with respect to excluded earned income. To determine the amount of disallowed taxes, multiply the tax imposed on earned income by a fraction the numerator of which is excluded earned income less deductible expenses definitely related in whole or in part to earned income, to the extent they are properly apportioned to excluded earned income (see § 1.911-5(a)), and the denominator of which is earned income less deductible expenses allocable to earned income. If the tax on earned income is imposed under foreign law on earned income and on some other amount (for example, some other type of income or an amount not subject to tax in the United States), the denominator equals the total of the amounts subject to the tax less deductible expenses allocable to all such amounts. The following examples illustrate the determination of foreign income taxes paid or accrued with respect to excluded earned income.

Example (1). A, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year as a bona fide resident of foreign country X. For 1981, A pays $10,000 in income tax to country X. The 10,000 tax is imposed after reduction for allocable expenses and personal deductions not allocable to any particular items of income, on the following amounts: $40,000 received in 1981 for services performed during that year; and $9,000 of unrealized capital gains with respect to stock and other securities owned by A. Of the $40,000 of earned income, $35,000 is qualifying earned income under § 1.911-2; the remaining $5,000 does not qualify for the section 911 exclusion because it is received for services performed in the United States. A incurred $4,000 of expenses which are deductible and allocable to A's earned income. A excludes $20,000 fo qualifying earned income from gross income for 1981. The $9,000 of unrealized capital gains is not subject to tax in the United States. In addition to the $10,000 tax on the above amounts, A pays a separate tax to country X of $800 on $8,000 of interest received during 1981. The amount of country X tax which is properly apportioned to excluded earned income (and, therefore, not deductible or creditable) equals $4,000, which is determined by multiplying the tax of $10,000 by the following fraction:

$$\frac{\text{\$18,000 (\$20,000 excluded earned income less \$2,000 of deductible expenses allocable to excluded income)}}{\text{\$45,000 (\$40,000 of earned income less \$4,000 of deductible expenses plus \$9,000 unrealized capital gains)}}$$

The separate $800 tax imposed on interest income is not apportioned in part to the excluded earned income, and the interest income is disregarded for purposes of apportioning the $10,000 tax.

Example (2). A, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year as bona fide resident of foreign country X. In 1981, A receives $50,000 of qualifying earned income for services performed during that year and excludes $20,000 of that income from gross income. Of the $50,000 received by A, $30,000 is for services performed in country X, and $20,000 is for services performed in country Y. Country Y does not tax A's income. Country X imposes a tax of $3,000 on the $30,000 received for services in country X but does not tax A's income received for services in country Y. The $20,000 exclusion is allocated on a pro rata basis between the portion of qualifying earned income subject to tax in country X and the portion not subject to tax. Thus, $12,000 ($20,000 exclusion X $30,000/$50,000) of the $30,000 subject to tax in country X is considered excluded under section 911. The amount of country X tax which is properly apportioned to excluded earned income equals $1,200, which is determined by multiplying the tax of $3,000 by the following fraction:

$$\frac{\text{\$12,000 (excluded earned income subject to country X tax)}}{\text{\$30,000 (income subject to country X tax)}}$$

§ 1.911-6 Procedural rules.

(a) *Election not to exclude earned income.* A taxpayer who is entitled to the benefit of section 911 may elect under section 911(d) not to exclude earned income as provided in section 911. This election shall be made on Form 2555, which must be filed either with the income tax return or with an amended return. The election is effective only for the taxable year for which the return is filed. The election may be revoked by filing a new Form 2555 with an amended return. An election not to exclude earned income as provided in section 911 enables a qualifying taxpayer, and in certain cases the taxpayer's spouse, to claim the benefits of section 913 (see § 1.913–2(a)). In addition, taxpayers who elect not to exclude income are not subject to the rules of § 1.911–5 relating to the disallowance of deductions and of the foreign tax credit.

(b) *Returns and extensions*—(1) *In general.* Any return filed before completion of the period necessary to qualify a taxpayer for the exclusion under section 911 or the deduction under section 913 shall be filed without regard to the exclusion or deduction provided in those sections. A claim for a credit or refund of any overpayment of tax may be filed, however, if the taxpayer subsequently qualifies for the exclusion or deduction. See section 6012(c) and § 1.6012–1(a)(3), relating to returns to be filed and information to be furnished by taxpayers who qualify for the exclusion under section 911.

(2) *Extensions.* A taxpayer desiring an extension of time (in addition to the automatic extension of time granted by § 1.6081–2) for filing a return until after the completion of the qualifying period described in § 1.913–2(a)(1) or (2) for claiming either the exclusion under section 911 or the deduction under section 913 may apply for an extension on Form 2350, Application for Extension of Time for Filing United States Income Tax Return. The application must be filed with the Director, Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The application must set forth the facts relied upon to justify the extension of time requested and must include a statement as to the earliest date the taxpayer expects to be entitled to the exclusion or deduction.

(c) *Declaration of Estimated Tax.* In estimating gross income for the purpose of determining whether a declaration of estimated tax must be made for any taxable year, a taxpayer is not required to take into account income which the taxpayer believes will be excluded from gross income under the provisions of section 911. In computing estimated tax, however, the taxpayer must take into account, among other things, the denial of the foreign tax credit for foreign taxes allocable to the excluded income (see § 1.911–5(b)).

§ 1.911–7 Effective date of §§ 1.911–1 through 1.911–6.

Sections 1.911–1 through 1.911–6 apply to taxable years beginning after December 31, 1978. Those sections also apply to the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95–615, 92 Stat. 3109) to have prior law apply to that taxable year. Prior law is section 911 as amended by section 1011 (a), (b), and (c) of the Tax Reform Act of 1976 (Pub. L. 94–455, 90 Stat. 1610) and by section 701(u)(10) of the Revenue Act of 1978 (Pub. L. 95–600, 92 Stat. 2917). For the rules applicable to earlier taxable years, see 26 C.F.R. §§ 1.911–1 and 1.911–2 (1978).

Par. 2. Sections 5b.913–1 through 5b.913–13 are deleted and the following §§ 1.913–1 through 1.913–13 are adopted.

Sec.

§ 1.913–1 Deduction for certain expenses of living abroad.

(a) *In general.* Section 913 allows to qualifying taxpayers a deduction which consists of the following amounts:

(1) The cost-of-living differential described in § 1.913–5;

(2) Qualified housing expenses described in § 1.913–6;

(3) Qualified school expenses described in § 1.913–7;

(4) Qualified home leave transportation expenses described in § 1.913–8; and

(5) The hardship area amount described in § 1.913–9.

The section 913 deduction is a deduction from gross income and is limited to the amount of the foreign source earned income limitation described in § 1.913–4. In addition, special rules in § 1.913–10 apply to married couples, both spouses of which qualify for the section 913 deduction.

(b) *Relation to the foreign tax credit.* The amount of foreign taxes for which a credit may be claimed, determined prior to the application of the limitation of section 904, is not reduced as a result of claiming the benefits of section 913. The section 913 deduction, however, is allocable to income from sources without the United States for purposes of computing the foreign tax credit limitation under section 904.

§ 1.913–2 Taxpayers qualifying for the deduction.

(a) *In general.* A taxpayer qualifies for the section 913 deduction if the taxpayer either—

(1) Is a citizen of the United States and establishes to the satisfaction of the Commissioner that the taxpayer has been a *bona fide* resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year; or

(2) Is a citizen or resident individual of the United States and has been present in a foreign country or countries for at least 510 full calendar days of any period of 18 consecutive months.

A taxpayer does not qualify for the section 913 deduction during a taxable year, however, if the taxpayer excludes from gross income under section 911 any earned income attributable to services performed during that taxable year. In addition, a taxpayer does not qualify for the section 913 deduction for any period during which the taxpayer's spouse derives earned income which is excluded from gross income under section 911 unless the taxpayer's spouse maintains a separate abode which is not within a reasonable commuting distance of the taxpayer's abode.

(b) *Determination of bona fide residence.* Whether a taxpayer is a *bona fide* resident of a foreign country shall be determined by applying, to the extent possible, the principles of section 871 and the regulations thereunder for determining the residence of aliens. Though the period of *bona fide* residence must be uninterrupted, if *bona fide* residence in a foreign country or countries is established, temporary visits to the United States or elsewhere on vacation or business during the taxpayer's period of residence will not necessarily nullify the taxpayer's status as a *bona fide* resident of a foreign country. A taxpayer with earned income from sources within a foreign country is not a *bona fide* resident of that country if—

(1) The taxpayer makes a statement to the authorities of the foreign country claiming to be a nonresident of that country and

(2) The taxpayer is held not subject as a resident of the foreign country to the income tax imposed by that country on such income.

If a taxpayer has made a statement of nonresidence to the authorities of a foreign country which is pending as of any date a determination of the taxpayer's *bona fide* residence is being made, the taxpayer is not considered a *bona fide* resident of the foreign country as of that date.

(c) *The 510-day/18-month requirement*—(1) *In general.* For purposes of paragraph (a)(2) of this section, the term "18 consecutive months" means any period of 18 months duration. The 18-month period may begin with any day of the calendar month. The period ends with the day before the corresponding calendar day in the 18th succeeding month or, if there is no corresponding calendar day, with the last day of the 18th succeeding month. The 18-month period may commence before or after the taxpayer's arrival in a foreign country and may terminate before or after the taxpayer's departure. The 510 full days need not be consecutive, but may be interrupted by periods during which the taxpayer is not present in a foreign country. A taxpayer who has been present in a foreign country and then travels over areas not within any country for less than 24 hours shall not be deemed outside the foreign country during the period of travel, so long as the individual does not travel within the United States. Time spent in a foreign country in the employment of the U.S. government or an agency or instrumentality of the U.S. government counts toward satisfaction of the 510-day requirement. In addition, time spent in a foreign country prior to January 1, 1978, counts toward satisfaction of the 510-day requirement, even though no deduction is allowed under section 913 for that time.

(2) *Illustrations of the 510-day rule.* The 510-day rule is illustrated by the following examples:

Example (1). B, a U.S. citizen, arrives in Venezuela from New York at 12 noon on April 24, 1980. B remains in Venezuela until 2 p.m. on October 25, 1981, at which time B departs for the United States where B remains for the rest of 1981. B is in a foreign country an aggregate of 510 full days during each of the following two 18-month periods: March 17, 1980, through September 16, 1981; and June 2, 1980, through December 1, 1981.

Example (2). C, a resident alien of the United States, travels extensively from the time C leaves the United States on March 6, 1980, until the time C departs England on January 1, 1982, to return to the United States permanently. The schedule of C's travel and the number of full days at each location are listed below:

Country	Time and date of arrival	Time and date of departure	Full days in foreign country
United States		10 p.m. (by air) Mar. 5, 1980	
England	9 a.m., Mar. 6, 1980	10 p.m. (by ship) June 25, 1980	110
United States	11 a.m., June 30, 1980	1 p.m. (by ship) July 19, 1980	0
France	3 p.m., July 24, 1980	11 a.m. (by air) Aug. 22, 1981	393
United States	4 p.m., Aug 22, 1981	9 p.m. (by air) Sept. 4, 1981	0
England	9 a.m., Sept. 5, 1981	9 a.m. (by air) Jan 1, 1982	117
United States	1 p.m., Jan. 1, 1982		

C is not present in a foreign country or countries an aggregate of 510 full days during the 18-month period beginning March 7, 1980 (C's first full day in a foreign country). However, C is present in a foreign country or countries an aggregate of 510 full days during the following 18-month periods: July 1, 1980, through December 31, 1981; and July 25, 1980, through January 24, 1982. The computation with respect to each period may be illustrated as follows:

	Full days in foreign country
First 18-month period (Mar. 7, 1980, through Sept 6, 1981):	
Mar. 7, 1980, through June 24, 1980	110
June 25, 1980, through July 24, 1980	0
July 25, 1980 through Aug. 21, 1981	393
Aug. 22, 1981, through Sept. 5, 1981	0
Sept. 6, 1981	1
Total full days	504
Second 18-month period (July 1, 1980, through Dec. 31, 1981):	
July 1, 1980, through July 24, 1980	0
July 25, 1980, through Aug. 21, 1981	393
Aug. 22, 1981, through Sept. 5, 1981	0
Sept. 6, 1981, through Dec. 31, 1981	117
Total full days	510
Third 18-month period (July 25, 1980, through Jan. 24, 1982):	
July 25, 1980, through Aug. 21, 1981	393
Aug. 22, 1981, through Sept. 5, 1981	0
Sept. 6, 1981, through Dec 31, 1981	117
Jan. 1, 1982, through Jan 24, 1982	0
Total full days	510

Example (3). The facts are the same as in example (2), except that C arrives in in England on February 25, 1980, instead of March 6, 1980. As a result, C is present in a foreign country or countries an aggregate of 510 full days during the 18-month period February 19, 1980, through August 18, 1981, as well as during the latter two of the three periods listed in example (2). The computation with respect to the period commencing February 19, 1980, is illustrated below:

	Full days in foreign country
Feb. 19, 1980, through Feb. 25, 1980	0
Feb. 26, 1980, through June 24, 1980	120
June 25, 1980, through July 24, 1980	0
July 25, 1980, through Aug 18, 1981	390
Total full days	510

Because the 18-month periods commencing February 19, 1980, and July 25, 1980 (the third 18-month period in example (2)), fully overlap the 18-month period commencing July 1, 1980 (the second 18-month period in example (2)), that latter period need not be considered in determining whether C qualifies under the 510-day rule for the days covered by that period.

§ 1.913-3 General definitions.

(a) *Tax home.* For purposes of section 913 and the regulations thereunder, the term "tax home" has the same meaning which it has for purposes of section 162(a)(2). An exception to the general rule is that a taxpayer shall not be considered to have a tax home in a foreign country for any period for which the taxpayer's abode is in the United States. For example, a taxpayer who lives in Detroit, Michigan, but commutes daily to work in Windsor, Ontario, would ordinarily have his or her tax home in Windsor but nevertheless would be ineligible for the deduction for excess foreign living costs. Temporary presence of the taxpayer in the United States does not necessarily mean that the taxpayer's abode is in the United States during that time.

(b) *Qualified second household.*—(1) *In general.* A qualified second household is a separate household maintained by a taxpayer for the taxpayer's spouse or dependents who, if minors, are in the taxpayer's legal custody or the joint custody of the taxpayer and spouse. In order to be a qualified second household, the separate household must be maintained in a foreign country at a place other than the tax home of the taxpayer and must be provided because of adverse living conditions at the taxpayer's tax home. The taxpayer's tax home need not be in a hardship area (defined in paragraph (e) of this section) in order for the separate household to be a qualified second household. In no circumstances is a taxpayer considered to maintain more than one qualified second household at the same time.

(2) *Adverse living conditions.* Adverse living conditions are living conditions which are dangerous, unhealthy, or otherwise adverse. If a taxpayer's tax home is in a hardship area (defined in paragraph (e) of this section), living conditions will be considered to be adverse. Adverse living conditions include a state of warfare or civil insurrection in the general area of the taxpayer's tax home. Adverse living conditions exist if the taxpayer's abode is on the business premises of the employer for the convenience of the employer and, because of the nature of the business premises (for example, a construction site or drilling rig), it is not feasible to provide family housing. The criteria used by the U.S. Department of State in granting a separate maintenance allowance are relevant but not determinative for purposes of determining whether a separate household is provided because of adverse living conditions.

(c) *United States.* The term "United States" when used in a geographical sense includes the possessions of the United States and the areas set forth in section 638(1). It also includes areas described in section 638(2) to the extent that they relate to U.S. possessions.

(d) *Foreign country.* The term "foreign country" means any territory under the sovereignty of a government other than that of the United States. It includes the air space over any such territory. It does not include a possession or territory of the United States.

(e) *Hardship area.* A hardship area is any place in a foreign country (defined in paragraph (d) of this section) which is designated by the Secretary of State as a place where living conditions are extraordinarily difficult or notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925 of Title 5 of the U.S. Code to any officer or employee of the U.S. Government present at that place. Taxpayers who wish to apply for a hardship area determination must apply to the State Department Allowances Staff, Department of State, Washington, D.C. 20520.

(f) *Reasonable commuting distance.* For purposes of sections 911 and 913, a reasonable commuting distance is a distance which is capable of being traveled safely and regularly by customarily available water transportation, including privately owned vehicles in 1 hour.

§ 1.913-4 Foreign source earned income limitation.

(a) *In general.* The deduction allowed under section 913 may not exceed foreign source earned income reduced by the portion of definitely related deductions (within the meaning of § 1.861-8), other than the deduction allowed by section 913, that is properly apportioned to such income. For purposes of this section deductions that are not definitely related, such as personal and family medical expenses, real estate taxes, mortgage interest on a personal residence, charitable contributions, and deductions for personal exemptions do not reduce foreign source earned income.

(b) *Foreign source earned income.* For purposes of the regulations under section 913, foreign source earned income is the earned income (defined in § 1.911-2(b)) which—

(1) Is derived by the taxpayer and, if the taxpayer's spouse shares the taxpayer's abode, by the taxpayer's spouse;

(2) Is attributable to services performed outside the United States during portions of the taxable year during which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2(a) for the section 913 deduction;

(3) Is not excluded from gross income under section 119; and

(4) Satisfies the requirements of § 1.911-2(a) (2), (3), and (4).

For purposes of paragraph (b)(2) of this section, the place of receipt of income is immaterial in determining whether income is attributable to services performed outside the United States.

§ 1.913-5 Cost-of-living differential.

(a) *In general.* The cost-of-living differential for an entire taxable year is the amount specified in tables issued annually by the Internal Revenue Service for the taxpayer's tax home and family size multiplied by the following fraction:

$$\frac{\text{Number of qualifying days}}{\text{Number of days in the taxable year}}$$

The amount which is the cost-of-living differential must be reduced (but not below zero) by the amount of any military or section 912 allowance excludable from gross income of the taxpayer or the taxpayer's spouse which is intended to compensate such person in whole or in part for the cost-of-living of the taxpayer's household (or in a qualified second household).

(b) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2(a) for the section 913 deduction, excluding days for which both meals and lodging are furnished to the taxpayer and the value of both is excluded from the taxpayer's gross income under section 119.

(c) *Change of foreign tax home*—(1) *In general.* If during the taxable year the taxpayer has more than one foreign tax home, the taxpayer must determine the qualifying days with respect to each foreign tax home and compute a separate cost-of-living amount for each pursuant to the rules of this section. The aggregate of those amounts constitutes the taxpayer's cost-of-living differential for the year.

(2) *Illustration.* If the taxpayer's tax home is West Berlin, West Germany, for 200 qualifying days and Paris, France, for 165 qualifying days during the taxable year, the taxpayer must compute two cost-of-living amounts. The first equals the full year's cost-of-living differential specified in the cost-of-living table for West Berlin multiplied by 200/365. The second equals the full year's cost-of-living differential specified for Paris multiplied by 165/365. The sum of the two amounts so computed constitutes the taxpayer's cost-of-living differential for the taxable year.

(d) *Family size*—(1) *In general.* In determining family size, the family includes only the taxpayer and any spouse and dependents who share the taxpayer's abode. A dependent may be considered to share the taxpayer's abode while boarding at a school only if the expenses of room and board are not deducted as qualified schooling expenses. In addition, no person is considered to share the taxpayer's abode during any days for which both meals and lodging are furnished to that person and the value of both is excluded from gross income under section 119. If family size varies during any period within the taxable year during which the taxpayer has a particular foreign tax home, a separate cost-of-living amount must be computed for each portion of that period during which the family size is different. An exception to this general rule is that a dependent who is born during a taxable year is considered to be a family member for the entire taxable year. Those amounts must then be aggregated to determine the cost-of-living differential for the taxable year.

(2) *Illustration.* If all of the days of a taxable year are qualifying days with respect to one foreign tax home and an unmarried taxpayer's only dependent attends a secondary level boarding school for 274 days of the year and lives with the taxpayer during the remaining 91 days, the taxpayer must compute two cost-of-living amounts. The first equals the full year's cost-of-living differential specified in the cost-of-living table for the taxpayer's tax home for a family size of one multiplied by 274/365. The second equals the full year's cost-of-living differential specified for the taxpayer's tax home for a family of two multiplied by 91/365. The sum of the two amounts so computed constitutes the taxpayer's cost-of-living differential for the taxable year.

(e) *Special rules for qualified second households*—(1) *In general.* The cost-of-living differential for the portion of the taxable year during which the taxpayer maintains a qualified second household (defined in § 1.913-3(b)) is determined on the basis of the amount specified for the location of the taxpayer's qualified second household. No cost-of-living differenial is determined for the taxpayer's tax home for any period during which the taxpayer maintains a qualified second household.

(2) *Qualifying days.* In determing under paragraph (b) of this section the number of qualifying days during which the taxpayer maintains a qualified second household, the number of qualifying days is not reduced by days

during which the value of the taxpayer's meals and lodging is excluded from gross income under section 119.

(3) *Family size.* Family size is determined as provided in paragraph (d) of this section, except that the family includes only the spouse and any dependents whose abode is the qualified second household. Regardless of whether the taxpayer is actually present in the qualified second household, the taxpayer is considered a family member except during days for which both meals and lodging are furnished to the taxpayer and the value of both is excluded under section 119.

§ 1.913-6 Qualified housing expenses.

(a) *In general.* The amount of qualified housing expenses equals the reasonable housing expenses incurred by or on behalf of the taxpayer and any spouse and dependents who share the taxpayer's abode less the taxpayer's base amount. The amount of qualified housing expenses must be reduced, however, by the amount of any military or section 912 allowance excludable from gross income which is intended to compensate in whole or in part for the expenses of housing located within a reasonable commuting distance of the taxpayer's tax home. Any amount required to be included in income of the taxpayer as compensation attributable to housing provided to the taxpayer shall be considered incurred on behalf of the taxpayer for housing in a foreign country.

(b) *Housing expenses*—(1) *In general.* Housing expenses include rent, utilities (other than long distance telephone charges), real and personal property insurance, occupancy taxes not described in paragraph (b)(1)(v) of this section, nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, residential parking, and repairs. Housing expenses do not include—

(i) The cost of house purchase, improvements and other costs which are capital expenditures;

(ii) The cost of purchased furniture or accessories or domestic labor (maids, gardeners, etc.);

(iii) Amortized payments of principal with respect to an evidence of indebtedness secured by a mortgage on the taxpayer's housing;

(iv) Depreciation of housing owned by the taxpayer, or amortization or depreciation of capital improvements made to housing leased by the taxpayer; or

(v) Interest and taxes deductible under section 163 or 164 or other amounts deductible under section 216 (a).

(2) *Limitation.* Housing expenses are taken into account for purposes of this section only to the extent that they are attributable to housing for portions of the taxable year during which—

(i) The taxpayer's tax home is in a foreign country;

(ii) The value of the taxpayer's housing is not excluded under section 119; and

(iii) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction.

In addition, except as provided in paragraph (d)(1) of this section relating to qualified second households, if the taxpayer maintains more than one foreign abode at the same time, housing expenses are to be taken into account only to the extent that they are incurred with respect to the abode which bears the closest relationship (not necessarily geographic) to the taxpayer's tax home.

(3) *Reasonableness.* An amount paid for housing is reasonable for purposes of paragraph (a) of this section only to the extent that it does not exceed an amount which would be paid for housing which is not lavish or extravagant under the circumstances.

(c) *Base housing amount*—(1) *In general.* The base housing amount equals 20 percent of the excess of the taxpayer's worldwide earned income over the sum of the following amounts—

(i) The portion of definitely related deductions (within the meaning of § 1.861-8), other than the deduction allowed under section 913, which is allocable to worldwide earned income;

(ii) The cost-of-living differential (determined under § 1.913-5);

(iii) The qualified school expenses (determined under § 1.913-7);

(iv) The qualified home leave transportation expenses (determined under § 1.913-8);

(v) The hardship area amount (determined under § 1.913-9); and

(vi) Housing expenses (defined in paragraphs (a) and (b) of this section).

(2) *Worldwide earned income.* Worldwide earned income is earned income (defined in § 1.911-2(b)), whether or not from sources outside the United States, which—

(i) Is derived by the taxpayer and, if the taxpayer's spouse shares the taxpayer's abode, by the taxpayer's spouse;

(ii) Satisfies the requirements of § 1.911-2(a)(2), (3), and (4); and

(iii) Is attributable to services performed during portions of the taxable year during which—

(A) The taxpayer's tax home is in a foreign country;

(B) The value of the taxpayer's housing is not excluded under section 119; and

(C) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction.

(d) *Special rules for qualified second households*—(1) *In general.* Qualified housing expenses may be claimed for housing expenses relating to the taxpayer's tax home and for housing expenses relating to a qualified second household. Qualified housing expenses are computed separately with respect to each.

(2) *Qualified housing expenses for the tax home.* In the case of a taxpayer who maintains a qualified second household, the qualified housing expenses for housing at the taxpayer's tax home are determined as provided in paragraphs (a), (b), and (c) of this section, except that, if the taxpayer's tax home is in a hardship area (defined in § 1.913-3 (e)), the base housing amount with respect to the tax home equals zero rather than the amount determined as provided in paragraph (c) of this section. In determining under paragraph (c) of this section the base housing amount of a taxpayer whose tax home is not in a hardship area, housing expenses in paragraph (c)(1)(vi) of this section do not include the housing expenses incurred with respect to the qualified second household.

(3) *Qualified housing expenses for the qualified second household*—(i) *Expenses.* In determining under paragraph (b) of this section the housing expenses relating to the qualified second household, the limitation of paragraph (b)(2)(ii) of this section does not apply, so that housing expenses may include those incurred for housing during portions of the taxable year during which the value of the taxpayer's housing at the taxpayer's tax home is excluded under section 119. In addition, the words "qualified second household" are substituted for "taxpayer's tax home" in paragraph (a) of this section. Thus, the amount of qualified housing expenses need not be reduced by the amount of any allowance excludable under section 912 for the expenses of housing lócated at the taxpayer's tax home, but must be reduced by the amount of any military or section 912 allowance excludable from gross income which compensates the taxpayer or the taxpayer's spouse in whole or in part for the expenses of housing at the location of the qualified second household.

(ii) *Base housing amount.* In determining under paragraph (c) of this section the base housing amount relating to the qualified second household—

(A) Housing expenses in paragraph (c)(1)(vi) of this section include those relating both to the qualified second household and to housing at the taxpayer's tax home;

(B) Paragraph (c)(2)(iii)(B) of this section does not apply, so that, subject to the other criteria of paragraph (c)(2) of this section, earned income used in computing the base housing amount includes income attributable to services performed during periods during which the value of the taxpayer's housing is excluded under section 119; and

(C) Worldwide earned income as defined in paragraph (c)(2) of this section does not include income attributable to services performed during any period during which the taxpayer does not maintain a qualified second household.

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

Example (1) All of the following facts relate to the entire 1980 taxable year. B qualifies for the section 913 deduction under § 1.913–2(a). B's tax home is in town X, located in foreign country F. Town X is not located in a hardship area. B's spouse and their 1-year old child live in a qualified second household in city Y in foreign country Z. B receives a $40,000 salary from B's corporate employer for services performed in country F and incurs no business expenses. B's employer also pays B a cost-of-living allowance of $4,000 and provides housing owned by the employer with a local fair market rental value of $10,000, for which the employer charges B $6,000. The value of the housing furnished by B's employer is not excluded from gross income under section 119. B's total earned income is, therefore, $48,000. B's spouse has no earned income. The cost-of-living differential specified in the 1980 cost-of-living table for country Z, the location of the qualified second household, is $3,000. B pays $15,000 for housing for B's spouse and child. Neither B nor B's spouse incurs any qualified school or home leave transportation expenses.

(a) The qualified housing expenses relating to the housing at B's tax home are computed by subtracting from $10,000 (the full value of B's housing) the base housing amount for the housing at B's tax home. The base housing amount for the housing at B's tax home is $7,000—20 percent of $35,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential and the $10,000 of housing expenses). Thus, the amount of qualified housing expenses relating to the housing at B's tax home equals $3,000.

(b) The qualified housing expenses relating to the qualified second household are computed by substracting from $15,000 (the housing expenses relating to the qualified second household) the base housing amount for the qualified second household. The base housing amount for the qualified second household is $4,000—20 percent of $20,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential, the $10,000 of housing expenses relating to the housing at B's tax home, and the $15,000 of housing expenses incurred with respect to the qualified second household). Thus, the amount of qualified housing expenses relating to the qualified second household equals $11,000.

(c) B's qualified housing expenses equal $14,000, which is the sum of the $3,000 qualified housing expenses relating to the housing at B's tax home and the $11,000 of qualified housing expenses relating to the qualified second household.

Example (2). The facts are the same as in example (1), except that town X is located in a hardship area. The qualified housing expenses relating to the housing at B's tax home equal $10,000, which is the full value of B's housing. The amount of qualified housing expenses relating to the qualified second household equals $11,000 and is computed in the same manner as in paragraph (b) of example (1). Thus, B's qualified housing expenses equal $21,000.

Example (3). The facts are the same as in example (1), except that there is no qualified second household, the cost-of-living differential specified in the 1980 cost-of-living table for country F (the location of B's tax home) is $3,000, and town X is located in a hardship area. The base housing amount for housing at B's tax home equals $6,000—20 percent of $30,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential, the $10,000 living expenses and the $5,000 hardship area differential). Thus, the amount of B's qualified housing expenses equals $4,000. Although B's tax home is located in a hardship area, B cannot claim as qualified housing expenses the full value of the housing provided at B's tax home, since B does not maintain a qualified second household.

§ 1.913–7 Qualified school expenses.

(a) *Qualified school expenses.* Qualified school expenses are reasonable school expenses incurred by or on behalf of the taxpayer for the education of a dependent of the taxpayer at levels equivalent to grades kindergarten through 12.

(b) *School expenses*—(1) *In general.* School expenses include tuition, fees, the cost of books, other amounts required by the school such as uniforms, and the cost of local transportation. Optional expenses, such as the cost of optional field trips or extracurricular activities, are not school expenses. If an adequate U.S.-type school is not available within a reasonable commuting distance (defined in § 1.913–3(f) of the taxpayer's tax home, the expenses of room and board for the dependent and the cost of transportation between the school and the taxpayer's tax home at the beginning and the end of the school year and during vacation periods are also school expenses. The cost of transportation includes transfer costs to and from the airport, airport taxes, exit fees or nonrefundable deposits made in order to leave the country, meals in route, and costs of involuntary stopovers in route. The cost of transportation does not include the costs of voluntary stopovers in route.

(2) *Limitation*—School expenses are qualified school expenses only to the extent that—

(i) They are not expenses for which a credit is claimed pursuant to section 44A (relating to child care) or for which a deduction is claimed pursuant to section 213 (relating to medical expenses);

(ii) They are not expenses for which the taxpayer or the taxpayer's spouse is compensated by an allowance such as the "school away from post" education allowance which is excluded from gross income under section 912;

(iii) They are attributable to education during a period in which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913–2(a) for the section 913 deduction; and

(iv) They are attributable to education during a period in which the dependent resides with the taxpayer at the taxpayer's tax home or in a qualified second household.

(c) *Reasonable expenses.* If an adequate U.S.-type school is available within a reasonable commuting distance (as defined in § 1.913–3(f) of the taxpayer's tax home, the taxpayer's dependents may attend school elsewhere, but tuition is considered reasonable only to the extent that it does not exceed the amount which would be incurred with respect to the school which is within commuting distance. If two or more adequate U.S.-type schools are available within a reasonable commuting distance of the taxpayer's tax home, tuition is considered reasonable only to the extent that it does not exceed the amount which would be incurred with respect to the least expensive of those schools. Round-trip transportation expenses are reasonable only to the extent that they do not exceed the lowest reserved coach or economy rate which is offered without advance booking on the day and at the time of day that the dependent travels. First class fares are considered reasonable only if no coach or economy accommodations are provided to any passengers on the particular flight or if the dependent is required to use first class accommodations because of physical impairment. In addition, the cost of transportation by modes other than air (including ship, rail, and automobile) is not considered reasonable to the extent that the cost of transportation by such other modes exceeds the cost of transportation by air.

(d) *Availability and adequacy.* A school is not considered available under paragraphs (b) and (c) of this section if the school will not accept the taxpayer's dependents for enrollment. A school is not adequate if, because of physical impairment or learning disabilities, the dependent is in need of special educational facilities or training which the school does not provide. A school is not adequate if the dependent desires a college preparatory curriculum and the school does not offer such a curriculum. In addition, a school is not adequate if it is under religious auspices which require religious training or infuse religious training in secular courses and the taxpayer does not send the dependent to another school under the same religious auspices. A school will be considered adequate even though it does not offer enrichment programs, if such programs would not ordinarily be offered in public elementary or secondary schools in the United States. Examples of such enrichment programs are a swimming team or orchestral training.

(e) *U.S.-type school.* A U.S.-type school is any school which offers a curriculum which—

(1) Is taught in English;

(2) Is comparable to that offered by accredited schools in the United States; and

(3) Would qualify the student for graduation if the student were to transfer to a U.S. school.

(f) *Special rules for qualified second households.* If the taxpayer maintains a qualified second household (defined in § 1.913–3(b)), the location of the taxpayer's qualified second household rather than the taxpayer's tax home is to be used to determine what constitutes school expenses under paragraph (b)(1) of this section and whether school expenses are reasonable under paragraph (c) of this section.

§ 1.913–8 Qualified home leave transportation expenses.

(a) *In general.* Qualified home leave transportation expenses are the resonable expenses incurred by or on behalf of the taxpayer for the transportation during the taxable year of the taxpayer or of the taxpayer's spouse or dependents. The expenses must be incurred for round-trip transportation from the location of the taxpayer's tax home (or, with respect to the spouse and dependents, from a qualified second household) to the taxpayer's present or most recent principal residence (whether owned or rented) in the United States or to the port of entry in the continental United States (excluding Alaska) which is nearest to the taxpayer's tax home (or qualified second household). Qualified transportation expenses include transfer costs to and from the airport, airport taxes, exit fees or nonrefundable deposits made in order to leave the country, meals in route, and the costs of involuntary stopovers in route. The cost of transportation does not include the costs of voluntary stopovers in route.

(b) *Limitations*—(1) *One trip for each 12-month period abroad.* Qualified transportation expenses include the cost of no more than one round trip per person for each period of 12 consecutive months (which do not overlap) during which—

(i) The taxpayer's tax home is in a foreign country; and

(ii) The taxpayer qualifies under § 1.913–2(a) for the section 913 deduction.

The trip can occur before completion of a 12-month period.

(2) *Spouse and dependents.* Home leave transportation expenses may be claimed for the transportation of a spouse or dependent only if, at the time of the transportation, the spouse or dependent resides with the taxpayer at the taxpayer's tax home or in a qualified second household.

(3) *Double benefits denied.* Qualified transportation expense for each period of 12 consecutive months must be reduced by the amount of any allowance which is granted to the taxpayer or the taxpayer's spouse for purposes of home leave transportation at any time during that period of 12 consecutive months and which is excluded from gross income under section 912.

(c) *Reasonableness.* In determining whether transportation expenses are reasonable, the rules of § 1.913–7(c) (qualified school expenses) as they relate to transportation apply.

§ 1.913–9 Hardship area amount.

(a) *Hardship area amount.* The hardship area amount for an entire taxable year equals $5,000 multiplied by the following fraction:

$$\frac{\text{The number of qualifying days.}}{\text{The total number of days in the taxable year.}}$$

(b) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the following requirements are satisfied:

(1) The taxpayer's tax home is located in a hardship area (defined in § 1.913–3(e)); and

(2) The taxpayer qualifies under § 1.913–2(a) for the section 913 deduction.

A taxpayer's tax home is not considered to be located in a hardship area during any day for which the area where the taxpayer's tax home is located is not designated as a hardship area. To determine the number of days during which the taxpayer's tax home is located in an area designated as a hardship area, see the hardship area list. (The hardship area list is contained in the instructions to Form 2555 or may be obtained from the Director of International Operations, CP:OIO:8, Internal Revenue Service, Washington, D.C. 20225. Taxpayers who wish to apply for a hardship area determination must apply to the State Department Allowances Staff, Department of State, Washington, D.C. 20520.

§ 1.913–10 Married couples with two qualifying spouses.

(a) *In general.* Subject to the rules of this section, in the case of a married couple both spouses of which qualify for the deduction provided in section 913, both spouses may claim the benefit of the deduction. If both spouses claim the benefit of section 913 directly as qualifying taxpayers, however, neither may claim any benefits of section 913 relating to a qualified second household maintained for the other spouse. If one spouse foregoes the benefits which that spouse, as a qualifying taxpayer, could claim under section 913, the other spouse may claim the benefits of section 913 relating to a qualified second household maintained for the first spouse. In such case, the earned income of both spouses is considered in computing the foreign earned income limitation under § 1.913–4 and base housing amount under § 1.913–6(c) of the spouse who claims the benefits of section 913. The rules in paragraphs (b) through (g) of this section apply only to married couples both spouses of which qualify for the deduction provided in section 913 and neither spouse of which claims any benefits relating to a qualified second household maintained for the other spouse.

(b) *Foreign source earned income limitation.* If separate returns are filed and both spouses claim the section 913 deduction, the foreign source earned income limitation for purposes of the separate return of each spouse is computed as provided in § 1.913–4, except that it is to be computed solely on the basis of the earned income derived by that spouse (without regard to community income laws). Otherwise, the limitation is computed as provided in § 1.913–4—that is, on the basis of the combined earned income of both spouses unless they maintain separate abodes.

(c) *Cost-of-living differential.* Except as provided in paragraph (g) of this section, only one cost-of-living differential is permitted for the couple. If separate returns are filed, each spouse's cost-of-living differential equals one-half of the differential computed for the couple.

(d) *Qualified housing expenses*—(1) *Expenses*. Except as provided in paragraph (g) of this section, a married couple may claim qualified housing expenses with respect to only one abode.

(2) *Base housing amount*. If separate returns are filed and both spouses claim the section 913 deduction, the base housing amount for purposes of the separate return of each spouse is computed as provided in § 1.913–6(c), except that it is to be computed solely on the basis of the earned income derived by that spouse (without regard to community income laws). The aggregate of the qualified housing expenses which may be claimed on separate returns may not exceed, however, the amount which would be computed for the couple if a joint return were filed. If separate returns are not filed or if both spouses do not claim the section 913 deduction, the base housing amount is computed as provided in § 1.913–6(c)—that is, on the basis of the combined earned income of both spouses unless they maintain separate abodes.

(e) *Qualified home leave transportation expenses*. Pursuant to § 1.913–8(b)(3), a married couple may not include as qualified home leave transportation expenses the cost of more than one round trip for each spouse or dependent for each period of 12 consecutive months during which the couple's tax home is in a foreign country, even though both spouses independently qualify under § 1.913–2(a) for the section 913 deduction.

(f) *Hardship area amount and joint returns*. Subject to the rules of § 1.913–9, each spouse may claim a hardship area amount. If joint returns are filed, however, the hardship area amount determined for each spouse may not exceed the foreign earned income limitation computed as provided in § 1.913–4, except that it is to be computed solely on the basis of the earned income derived by that spouse (without regard to community income laws).

(g) *Separate tax homes*—(1) *In general*. A married couple that maintains separate abodes may claim a cost-of-living differential and qualified housing expenses with respect to each abode if—

(i) The abodes are not within a reasonable commuting distance of each other; and

(ii) The spouses have different tax homes which are not within a reasonable commuting distance of each other.

(2) *Joint returns*. If under paragraph (g)(1) a cost-of-living differential or qualified housing expenses are claimed with respect to the separate abode of each spouse and a joint return is filed, the aggregate of the following amounts may not exceed the foreign earned income limitation computed as provided in § 1.913–4 solely on the basis of the earned income derived by each spouse (without regard to community income laws):

(i) The cost-of-living differential determined as provided in § 1.913–5 with respect to that spouse's tax home;

(ii) The qualified housing expenses incurred with respect to that spouse's abode determined by using a base housing amount computed as provided in § 1.913–6(c) solely on the basis of the earned income derived by that spouse (without regard to community income laws); and

(iii) The hardship area amount for that spouse.

§ 1.913–11 Married couples with community income.

(a) *Joint return*. Married couples with community earned income who file a joint return must compute their section 913 deduction under the rules of §§ 1.913–1 through 1.913–10. Where relevant, those rules instruct taxpayers with community income to disregard community income laws and treat the income earned by each spouse solely as that spouse's income.

(b) *Separate returns*. Married couples with community earned income (other than taxpayers to whom section 879 applies) who file separate returns must first compute the section 913 deduction as if they filed a joint return. One-half of that amount is the section 913 deduction to be claimed by each spouse on a separate return.

§ 1.913–12 Returns and extensions.

See § 1.911–6(b) relating to returns and extensions for taxpayers qualifying for the section 913 deduction.

§ 1.913–13 Effective date.

Sections 1.913–1 through 1.913–12 apply to taxable years beginning after December 31, 1978. Those sections also apply to the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95–615, 92 Stat. 3109) to have section 911 under prior law apply to that taxable year.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805) and, in part, under the authority contained in section 913(m) of the Code (92 Stat. 3106; 26 U.S.C. 913(m)).

Par. 3. The sixth sentence of paragraph (d) of § 1.953–2 is amended to read as follows:

§ 1.953–2 Actual United States risks.

* * * * *

(d) *Lives or health of United States residents*. * * * In determining the country of residence of an insured, the principles of §§ 1.871–2 to 1.871–5 inclusive and of § 1.913–2(b), relating to the determination of residence and nonresidence in the United States and of foreign residence, shall apply. * * *

* * * * *

Par. 4. Paragraph (a)(3) of § 1.981–1 is amended to read as follows:

§ 1.981–1 Foreign law community income for taxable years beginning after December 31, 1966.

(a) *Election for special treatment*. * * *

(3) *Determination of residence*. The principles of paragraphs (a)(2) and (b)(7) of § 1.911–1 (26 CFR § 1.911–1 (1978)) shall apply in order to determine for purposes of this paragraph whether a U.S. citizen is a *bona fide* resident of a foreign country or countries during the entire taxable year. The principles of §§ 1.871.2 through 1.871–5 shall apply in order to determine whether the alien spouse of a U.S. citizen is a nonresident during the entire taxable year.

* * * * *

Par. 5. The second sentence of paragraph (c)(4)(ii) of § 1.1303–1 is amended to read as follows:

§ 1.1303–1 Eligible individuals.

* * * * *

(c) *Individuals receiving support from others*. * * *

(4) *Spouse supported by others*. * * *

(ii) * * * For the definition of the term "earned income," see section 911(b) and § 1.911–2(b).

* * * * *

Par. 6. Paragraph (c) of § 1.6073–4 is redesignated as paragraph (d), and a new paragraph (c) is inserted to read as follows:

§ 1.6073–4 Extension of time for filing declarations by individuals.

* * * * *

(c) *Residents outside the United States*. In the case of a U.S. resident living or traveling outside the United States and Puerto Rico on the 15th day of the 4th month of a taxable year beginning after December 31, 1978, an extension of time for filing the declaration of estimated tax otherwise due on or before the 15th day of the 4th month of the taxable year is granted to and including the 15th day of the 6th month of the taxable year.

(d) *Addition to tax applicable.* * * *

Par. 7. The caption of § 1.6081-2 is revised and paragraph (a)(6) is inserted before the flush language of paragraph (a) of such section. Section 1.6081-2 as so amended reads as follows:

§ 1.6081-2 Extensions of time in the case of certain partnerships, corporations, and U.S. citizens and residents.

(a) *In general.* * * *

(6) U.S. residents living or traveling outside the United States and Puerto Rico, including persons in military or naval service on duty outside the United States and Puerto Rico but only with respect to taxable years beginning after December 31, 1977.

* * * * *

PART 5b [DELETED]

Par. 8. Since no sections remain in Part 5b, the part is deleted.

[FR Doc. 80-35989 Filed 11-14-80; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF DEFENSE

Corps of Engineers, Department of the Army

33 CFR Part 207

Banana River, Cape Canaveral Air Force Station—Restricted Area; Navigation Regulations

AGENCY: U.S. Army Corps of Engineers, DoD.

ACTION: Final rule.

SUMMARY: The Department of the Army, Corps of Engineers is establishing a restricted area in the Banana River adjacent to the Cape Canaveral Air Force Station, Patrick Air Force Base, Florida. The restricted area is necessary to prevent the entry of unauthorized vessels into the turning basin for security and safety purposes.

EFFECTIVE DATE: Effective on December 1, 1980.

ADDRESS: HQDA, DAEN-CWO-N, Washington, D.C. 20314.

FOR FURTHER INFORMATION CONTACT: Mr. Ralph T. Eppard at (202) 272-0200, or Mr. Lonnie Shepardson at (904) 791-2887.

SUPPLEMENTARY INFORMATION: On July 9, 1980, the U.S. Army Corps of Engineers published the proposal to establish a restricted area under 33 CFR 207.171b in the Notice of Proposed Rulemaking section of the **Federal Register** (45 FR 46094). These proposed regulations would establish a restricted area in the Banana River at the Cape Canaveral Air Force Station, Florida. There were no comments received in response to the Notice of Proposed Rulemaking. The Department of the Army has determined that the establishment of the restricted area is in the national interest. Accordingly, 33 CFR 207.171b is established as set forth below.

Note.—The Department of the Army has determined that this document does not contain a major proposal requiring preparation of a regulatory analysis under EO 12044, Improving Government Regulations (43 FR 12661, March 24, 1979).

(40 Stat. 266; 33 U.S.C. 1)

Dated: September 12, 1980.

Michael Blumenfeld,

Assistant Secretary of the Army (Civil Works).

§ 207.171b Banana River at Cape Canaveral Air Force Station, Fla., restricted area.

(a) *The Area.* (1) Starting at the northern boundary of the existing Prohibited Area as described in 33 CFR 207.171a, and the shoreline at latitude 28°28′58″N; Longitude 80°35′26″W; thence westerly along the northern boundary of 207.171a to latitude 28°28′58″N, longitude 80°35′43″W; thence N 04°06′25″E for 4760.11 feet to latitude 28°29′45″N, longitude 80°35′39″W; thence due east to a point on the shoreline at latitude 28°29′45″N, longitude 80°35′11″W.

(b) *The Regulation.* (1) All unauthorized craft shall stay clear of this area at all times.

(2) The regulations in this section shall be enforced by the Commander, Eastern Space and Missile Center, Patrick Air Force Base, Florida, and such agencies as he may designate.

(40 Stat. 266; 33 U.S.C. 1)

[FR Doc. 80-35904 Filed 11-17-80; 8:45 am]

BILLING CODE 3710-92-M

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 123

[SW-6-FRL 1672-1]

Arkansas: Phase I Interim Authorization of State Hazardous Waste Management Program

AGENCY: Environmental Protection Agency, Region 6.

ACTION: Approval of State program.

SUMMARY: The purpose of this notice is to grant Phase I interim authorization to the State of Arkansas for its hazardous waste management program.

In the May 19, 1980, **Federal Register** (45 FR 33063), the Environmental Protection Agency (EPA) promulgated regulations, pursuant to Subtitle C of the Resource Conservation and Recovery Act of 1976 (RCRA), to protect human health and the environment from the improper management of hazardous wastes. Included in these regulations, which become effective 6 months after promulgation, were provisions for a transitional stage in which states could be granted interim program authorization. The interim authorization program will be implemented in two phases corresponding to the two stages in which an underlying Federal program will take effect.

On September 11, 1980, the State of Arkansas applied to EPA for Phase I interim authorization of its hazardous waste management program. On September 18, 1980, EPA issued in the **Federal Register** (45 FR 62170) a notice of the public comment period on the State's application. All comments received during this period have been noted and considered, as discussed below.

The State of Arkansas is hereby granted interim authorization to operate the RCRA Subtitle C hazardous waste management program in accordance with section 3006 (c) of RCRA and implementing regulations found in 40 CFR 123 Subpart F.

EFFECTIVE DATE: November 19, 1980.

FOR FURTHER INFORMATION CONTACT: Thomas D. Clark, Solid Waste Branch, U.S. EPA, Region 6, 1201 Elm Street, Dallas, Texas 75270 (214) 767-2645.

SUPPLEMENTARY INFORMATION: The State of Arkansas submitted its draft application for Phase I interim authorization on July 30, 1980. After reviewing the document, EPA identified four areas of major concern, namely: (1) Deficiencies regarding the right of citizens to intervene in enforcement actions; (2) restrictions on availability to EPA of State program information without restriction; (3) lack of detail in the Authorization Plan; and (4) deficiencies in the Memorandum of Agreement between EPA and the State.

On September 11, 1980, the State of Arkansas submitted its final application for Phase I Interim Authorization. Because the application did not adequately address the first two areas, the State submitted supplemental information that satisfied EPA's concerns.

On September 26, 1980, the Arkansas Commission on Pollution Control and Ecology adopted a resolution endorsing the Federal requirements for public participation in enforcement actions.

In a letter dated September 29, 1980, the attorney authorized to sign the Attorney General's statement stated that "upon request from the EPA, any information obtained or used by this Department in the administration of the RCRA program may be available to EPA upon its request without any restrictions except those which are placed upon the EPA by any application laws or regulations." This letter clarified all stated reservations to possible restrictions on EPA's access to State program information.

The Authorization Plan submitted with the final application specifies with sufficient detail the actions the State will take to seek and obtain Phase II Interim Authorization and Final Authorization.

EPA's comments were satisfied in the Memorandum of Agreement submitted with the final application. In addition, the State submitted additional information about the Arkansas Transportation Commission's portion of the State hazardous waste program, including an elaboration of the Commission's responsibilities, enforcement authority, and coordination procedures.

As noticed in the **Federal Register** on September 18, 1980 (45 FR 62170), EPA gave the public until October 27, 1980, to comment on the State's application. EPA also held a public hearing in Little Rock, Arkansas, on October 20, 1980. The only comments received were presented at the public hearing.

An industry representative requested that the procedures for handling confidential information be revised so that EPA would request such information directly from the firm. The commenter was concerned that adequate protection of such information be provided.

EPA believes that confidential information will be adequately protected by the procedures set forth in 40 CFR Part 2. As discussed in the Attorney General's statement, there is adequate protection for information transmitted between EPA and the State through procedures that allow claims of confidentiality to be asserted and evaluated when such transfer of information occurs. Any information for which confidentiality is requested must be treated as such by both the State and EPA once the claim of confidentiality has been reviewed and its validity has been accepted.

The second commenter remarked that there were no guidelines or specifications for equipment to be used by transporters of hazardous wastes. The standards for transporters can be found in 40 CFR Part 263. Packaging requirements may also be found in 40 CFR Part 262. The other comment related to whether the State would have an adequate well-trained staff and proper funding to operate the program. EPA believes the State has adequate resources to operate Phase I of the program under interim authorization. The Department of Pollution Control and Ecology has submitted a budget to the State Legislature that should provide adequate resources to meet EPA's requirements for Phase II Interim Authorization. This budget request, of course, is subject to approval by the State Legislature.

Dated: November 10, 1980.

Adlene Harrison,

Regional Administrator.

[FR Doc. 80-35894 Filed 11-17-80; 8:45 am]

BILLING CODE 6560-38-M

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40 CFR Part 180

[PH FRL 1673-4; PP 9E2248/R289]

Malathion; Tolerances and Exemptions From Tolerances for Pesticide Chemicals in or on Raw Agricultural Commodities

AGENCY: Environmental Protection Agency (EPA).

ACTION: Final rule.

SUMMARY: This rule establishes tolerances for the insecticide malathion (*O,O*-dimethyl dithiophosphate of diethyl mercaptosuccinate). This regulation was requested by the Interregional Research Project No. 4 (IR-4). This regulation establishes the maximum permissible level for residues of malathion on flax seed at 0.1 part per million (ppm) and flax straw 1.0 ppm.

EFFECTIVE DATE: Effective on November 18, 1980.

ADDRESSES: Written objections may be submitted to the: Hearing Clerk, Environmental Protection Agency, Rm. M-3708 (A-110), 401 M St., SW., Washington, D.C. 20460.

FOR FURTHER INFORMATION CONTACT: Clinton Fletcher, Registration Division (TS-767), Office of Pesticide Programs, Environmental Protection Agency, Rm. E-124, 401 M St., SW., Washington, D.C. 20460, (202-426-0223).

SUPPLEMENTARY INFORMATION: EPA issued a notice that published in the **Federal Register** of October 10, 1980 (45 FR 67398) that the Interregional Research Project No. 4 (IR-4) has submitted a pesticide petition (PP 9E2248) to the EPA. The petition proposed the establishment of tolerances for flax seed at 0.1 ppm and flax straw at 1.0 ppm. No comments or requests for referral to an advisory committee were received by the agency, in response to this notice of proposed rulemaking.

The data submitted in the petition and all other relevant material have been evaluated. The pesticide is considered useful for the purpose for which the tolerances are sought. It is concluded that the tolerances will protect the public health. Therefore, 40 CFR Part 180 is amended as set forth below.

Any person adversely affected by this regulation, may within 30 days after publication of this notice in the **Federal Register**, file written objections with the Hearing Clerk, EPA, Rm. E-3708 (A-110), 401 M St. SW., Washington, D.C. 20460. Such objections should be submitted in quintuplicate and specify the provisions of the regulation deemed objectionable. If a hearing is requested, the objections must state the issues for the hearing. A hearing will be granted if the objections are legally sufficient to justify the relief sought.

Under Executive Order 12044, EPA is required to judge whether a regulation is "significant" and therefore subject to the procedural requirements of the Order or whether it may follow other specialized development procedures. EPA labels these other regulations "specialized." This regulation has been reviewed and it has been determined that it is a specialized regulation not subject to the procedural requirements of Executive Order 12044.

Effective on: November 18, 1980.

(Sec. 408(e), 68 Stat. 514, (21 U.S.C. 346a(e)))

Dated: November 13, 1980.

Edwin L. Johnson,

Deputy Assistant Administrator for Pesticide Programs.

Therefore, Subpart C of 40 CFR Part 180 is amended by alphabetically inserting "flax seed" and "flax straw" in the table under § 180.111 to read as follows:

§ 180.111 Malathion; tolerances for residues.

* * * * *