Internal Revenue
bulletin

Bulletin No. 2004-28
July 12, 2004

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 9132, page 16.

Final regulations under section 168 of the Code provide guidance on how to depreciate property for which the use changes in the hands of the same taxpayer. These regulations explain when a change in use occurs and how a taxpayer should determine depreciation in the year of the change in use, and in subsequent years.

T.D. 9133, page 25.

Final and temporary regulations under section 280F of the Code exclude vans and trucks that are qualified nonpersonal use vehicles (as defined in section 1.274–5T(k)) from the definition of "passenger automobile" for purposes of section 280F(a), including transition rules for property placed in service prior to July 7, 2003.

REG–131486–03, page 36.

Proposed regulations under section 1374 of the Code provide for an adjustment to the amount that may be subject to tax in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which section 1374(d)(8) applies. These regulations provide guidance to certain S corporations that acquire assets from a C corporation in a carryover basis transaction.

REG–117307–04, page 39.

Proposed regulations under section 864 of the Code relate to the application of the asset-use test to stock held by foreign insurance companies. The regulations provide that the exception to the asset-use test for stock does not apply in determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes income effectively connected with the conduct of a trade or business within the United States.

Notice 2004–41, page 31.

Charitable contributions and conservation easements. This notice informs taxpayers that the Service will, in appropriate cases, reduce or disallow deductions claimed by taxpayers under section 170 of the Code for transfers in connection with conservation easements. This notice also informs participants in these transactions that they may be subject to other adverse tax consequences, including penalties, excise taxes, and loss of tax-exempt status, as appropriate.

Notice 2004–44, page 32.

Section 368(a)(1)(B). The Service is requesting public comments regarding Rev. Proc. 81–70, 1981–2 C.B. 729, which contains the guidelines for estimating the basis of stock acquired in a B reorganization.

Notice 2004–45, page 33.

This notice advises taxpayers that the Service will challenge the meritless filing position of certain U.S. citizens who claim to be residents of the U.S. Virgin Islands and to have income from sources in the U.S. Virgin Islands or income effectively connected to the conduct of a trade or business in the U.S. Virgin Islands.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EMPLOYEE PLANS

Rev. Rul. 2004–67, page 28.

Group or pooled trusts; participation; tax-exempt status, model language. This ruling provides that a governmental section 457(b) plan may invest in a second tier group or pooled trust as long as the criteria enumerated in the ruling are met. In addition, the ruling sets forth model language that may be adopted by existing group or pooled trusts so that they need not request determination letters merely to add a provision permitting participation by a governmental section 457(b) plan. Rev. Rul. 81–100 clarified and modified.

EXEMPT ORGANIZATIONS

Announcement 2004–56, page 41.

This announcement is a public notice of the suspension of the federal tax exemption under section 501(p) of the Code of a certain organization that has been designated as supporting or engaging in terrorist activity or supporting terrorism. Contributions made to this organization during the period that the organization's tax-exempt status is suspended are not deductible for federal tax purposes.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(i)–1: General asset accounts.

T.D. 9132

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Changes in Use Under Section 168(i)(5)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the depreciation of property subject to section 168 of the Internal Revenue Code (MACRS property). Specifically, these regulations provide guidance on how to depreciate MACRS property for which the use changes in the hands of the same taxpayer. The regulations reflect changes to the law made by the Tax Reform Act of 1986.

DATES: *Effective Date*: These regulations are effective June 17, 2004.

Applicability Date: For dates of applicability, see §§1.168(i)–1(l)(2) and 1.168(i)–4(g).

FOR FURTHER INFORMATION CONTACT: Sara Logan or Kathleen Reed, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On July 21, 2003, the IRS and Treasury Department published a notice of proposed rulemaking in the **Federal Register** (REG–138499–02, 2003–37 I.R.B. 541 [68 FR 43047]), relating to a change in the use of MACRS property in the hands of the same taxpayer (change in the use) under section 168(i)(5) of the Internal Revenue Code (Code) and relating to a change in the use of assets in a general asset account under section 168(i)(4). On March 1, 2004, §§1.168(a)–1 and 1.168(b)–1 that were contained in this notice of proposed rulemaking were withdrawn (REG–138499–02, 2004–14 I.R.B. 704 [69 FR 9560]). No public hearing was requested or held. Written or electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

Scope

The final regulations provide the rules for determining the annual depreciation allowance under section 168 for MACRS property as a result of a change in the use of such property. Changes in the use include a conversion of personal use property to a business or income-producing use, a conversion of MACRS property to personal use, or a change in the use of MACRS property that results in a different recovery period, depreciation method, or both.

I. *Conversion to Business Use*

The final regulations retain the rules contained in the proposed regulations, providing that personal use property converted to business or income-producing use is treated as being placed in service by the taxpayer on the date of the conversion. Thus, the property is depreciated by using the applicable depreciation method, recovery period, and convention prescribed under section 168 for the property beginning in the taxable year the change in the use occurs (year of change). No comments were received suggesting changes to these rules. The final regulations, however, clarify that these rules do not apply when another section of the Code (or regulations under that section) prescribes the depreciation treatment for a change to business use. For example, if listed property (as defined in section 280F(d)(4)) is predominantly used by a taxpayer in a qualified business use in a taxable year, then in a subsequent taxable year is exclusively used by the taxpayer for personal purposes, and then in a later taxable year is predominantly used by the taxpayer in a qualified business use, section 280F(b)(2)(A) requires that the property be depreciated under the alternative depreciation system of section 168(g) in the later taxable year and subsequent taxable years.

II. *Conversion to Personal Use*

The final regulations retain the rule contained in the proposed regulations providing that a conversion of MACRS property from business or income-producing use to personal use is treated as a disposition of the property. Depreciation for the year of change is computed by taking into account the applicable convention. No gain, loss, or depreciation recapture is recognized upon the conversion. A commentator questioned whether recapture of excess depreciation under section 280F(b)(2) occurs upon a conversion of listed property from business use to only personal use. Upon this conversion, the listed property is not predominantly used in a qualified business use for that taxable year for purposes of section 280F(b) and, consequently, section 280F(b)(2) requires any excess depreciation (as defined in section 280F(b)(2)(B)) to be included in gross income for the taxable year in which the listed property is converted to personal use. Accordingly, the IRS and Treasury Department have included a cross-reference to section 280F(b)(2) in the final regulations.

III. *MACRS Property—Use Changes After Placed-In-Service Year*

The final regulations provide rules for MACRS property if a change in the use of the property occurs after the property's placed-in-service year but the property continues to be MACRS property in the hands of the taxpayer.

A. *Determination of a change in the use*

The final regulations remain unchanged from the proposed regulations. Consequently, a change in the use of MACRS property generally occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. However, in determining whether a taxpayer begins or ceases to use MACRS property predominantly outside the United States, the predominant use, instead of the primary use, of the MACRS property governs. A commentator questioned how this predominant use test is applied to rolling stock (for example, locomotives, freight and passenger train cars) that is not described under section 168(g)(4)(B) and that is used within and without the United States. This question concerns how to trace the movement of this rolling stock to determine its physical location, which the IRS and Treasury Department believe is beyond the scope of these regulations.

B. *Change in the use of MACRS property resulting in a different recovery period and/or depreciation method*

The final regulations retain the rules contained in the proposed regulations for determining the applicable depreciation method, recovery period, and convention used to determine the depreciation allowances for the MACRS property for the year of change and subsequent taxable years. Consequently, if a change in the use of MACRS property results in a shorter recovery period and/or a more accelerated depreciation method (for example, MACRS property ceases to be used predominantly outside the United States), the adjusted depreciable basis of the MACRS property as of the beginning of the year of change is depreciated over the shorter recovery period and/or by the more accelerated depreciation method beginning with the year of change as though the MACRS property is placed in service by the taxpayer in the year of change. If a change in the use of MACRS property results in a longer recovery period and/or a slower depreciation method (for example, MACRS property begins to be used predominantly outside the United States), the adjusted depreciable basis of the MACRS property as of the beginning of the year of change is depreciated over the longer recovery period and/or by the slower depreciation method beginning with the year of change as though the taxpayer originally placed the MACRS property in service with the longer recovery period and/or slower depreciation method.

A commentator suggested that the depreciation allowances for all changes in the use of MACRS property resulting in a different recovery period and/or depreciation method be determined beginning with the year of change by treating the new depreciation method and/or recovery period as though they applied from the date the MACRS property was originally placed in service by the taxpayer. The commentator, in effect, is requesting that the rule contained in the proposed regulations for a change in the use of MACRS property that results in a longer recovery period and/or slower depreciation method also apply to a change in the use of MACRS property that results in a shorter recovery period and/or a more accelerated depreciation method. The IRS and Treasury Department continue to believe that the rules contained in the proposed regulations are reasonable because the rules determine the depreciation allowance for any taxable year based on the primary use of the MACRS property by the taxpayer during that year. Further, for a change in the use of MACRS property that results in a shorter recovery period and/or a more accelerated depreciation method, the taxpayer either may determine the depreciation allowances as though the MACRS property is placed-in-service by the taxpayer in the year of change or may elect to disregard the change in the use and determine the depreciation allowances as though the change in the use had not occurred. As a result, the final regulations do not require a recovery period that is longer than the recovery period applicable for the MACRS property in the taxable year immediately preceding the year of change. Accordingly, the commentator's suggestion was not accepted.

Another commentator requested that *Example 4* in §1.168(i)–5(d)(6) be clarified by stating which optional depreciation tables the transaction coefficient factors are drawn from. The IRS and Treasury Department have adopted this suggestion.

IV. *Change in the Use During the Placed-in-Service Year*

The final regulations retain the rules contained in the proposed regulations if a change in the use of MACRS property occurs during the taxable year the property is placed in service and the property continues to be MACRS property in the hands of the taxpayer. Accordingly, if the use of MACRS property changes during its placed-in-service year, the depreciation allowance generally is determined by the primary use of the property during that taxable year. However, in determining whether MACRS property is used within or outside the United States during the placed-in-service year, the predominant use, instead of the primary use, of the MACRS property governs. Further, in determining whether MACRS property is tax-exempt use property or imported property covered by an Executive order during the placed-in-service year, the use of the property at the end of the placed-in-service year governs. Moreover, MACRS property is tax-exempt bond financed property during the placed-in-service year if a tax-exempt bond for the MACRS property is issued during the placed-in-service year.

V. *General Asset Accounts*

Finally, the regulations amend the final regulations under section 168(i)(4) (T.D. 8566, 1994–2 C.B. 20 [59 FR 51369] (1994)) and the temporary regulations under section 168(i)(4) (T.D. 9115, 2004–14 I.R.B. 680 [69 FR 9529] (2004)) for property accounted for in a general asset account for which the use of the property changes, resulting in a different recovery period and/or depreciation method. These amendments are the same rules contained in the proposed regulations.

Effective Dates

These regulations are applicable for any change in the use of MACRS property in a taxable year ending on or after June 17, 2004. For any change in the use of MACRS property after December 31, 1986, in a taxable year ending before June 17, 2004, the IRS will allow any reasonable method of depreciating the property under section 168 in the year of change and the subsequent taxable years that is consistently applied to the MACRS property for which the use changes in the hands of the same taxpayer. However, a taxpayer may choose, on a property-by-property basis, to apply the final regulations to a change in the use of MACRS property after December 31, 1986, in a taxable year ending before June 17, 2004. In this case and consistent with Chief Counsel Notice 2004–007, Change in Litigating Position—Application of Section 446(e) to Changes in Computing Depreciation (CC–2004–007, January 28, 2004, at the IRS Internet site at *www.irs.gov/foia*), a change to the method of accounting for depreciation provided in the final regulations due to a change in the use of MACRS property in a taxable year ending on or after December 30, 2003, is a change in method of accounting and a change to the method of accounting for depreciation provided in the final regulations due to a change in the use of MACRS property after December 31, 1986, in a taxable year ending before December 30, 2003, may be treated by the taxpayer as a change in method of accounting.

Special Analyses

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

Drafting Information

The principal author of these regulations is Sara Logan, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.168(i)–4 also issued under 26 U.S.C. 168(i)(5). * * *

Par. 2. Section 1.168(i)–0 is amended by revising the entry for §1.168(i)–1(h)(2) and adding entries for §1.168(i)–1(h)(2)(i) through (h)(2)(iii) to read as follows:

§1.168(i)–0 Table of contents for the general asset account rules.

* * * * *

§1.168(i)–1 General asset accounts.

* * * * *

(h) * * *

(2) Change in use results in a different recovery period and/or depreciation method.

(i) No effect on general asset account election.

(ii) Asset is removed from the general asset account.

(iii) New general asset account is established.

* * * * *

Par. 3. Section 1.168(i)–1 is amended by:

1. Revising paragraph (b)(1).

2. Amending paragraph (c)(2)(ii) by:

a. Removing the language "and" from the end of paragraph (c)(2)(ii)(C).

b. Removing the period "." from the end of paragraph (c)(2)(ii)(D) and adding "; and" in its place.

c. Revising paragraph (c)(2)(ii)(E).

3. Removing the language "the change in use occurs and" from the last sentence of paragraph (h)(1) and adding "the change in use occurs (the year of change) and" in its place.

4. Revising paragraph (h)(2).

5. Removing the language "(h)(1)" from paragraph (k)(1) and adding "(h)" in its place.

6. Revising paragraph (l).

The revisions read as follows:

§1.168(i)–1 General asset accounts.

* * * * *

(b) * * *

(1) *Unadjusted depreciable basis* is the basis of an asset for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations under the Internal Revenue Code (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

* * * * *

(c) * * *

(2) * * *

(ii) * * *

(E) Assets subject to paragraph (h)(2)(iii)(A) of this section (change in use results in a shorter recovery period and/or a more accelerated depreciation method) for which the depreciation allowance for the year of change (as defined in §1.168(i)–4(a)) is not determined by using an optional depreciation table must be grouped into a separate general asset account.

* * * * *

(h) * * *

(2) *Change in use results in a different recovery period and/or depreciation method*—(i) *No effect on general asset account election*. A change in the use described in §1.168(i)–4(d) (change in use results in a different recovery period and/or depreciation method) of an asset in a general asset account shall not cause or permit the revocation of the election made under this section.

(ii) *Asset is removed from the general asset account*. Upon a change in the use described in §1.168(i)–4(d), the taxpayer must remove the asset from the general asset account as of the first day of the year of change and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section. If, however, the result of the change in use is described in §1.168(i)–4(d)(3) (change in use results in a shorter recovery period and/or a more accelerated depreciation method) and the taxpayer elects to treat the asset as though the change in use had not occurred pursuant to §1.168(i)–4(d)(3)(ii), no adjustment is made to the general asset account upon the change in use.

(iii) *New general asset account is established*—(A) *Change in use results in a shorter recovery period and/or a more accelerated depreciation method.* If the result of the change in use is described in §1.168(i)–4(d)(3) (change in use results in a shorter recovery period and/or a more accelerated depreciation method) and adjustments to the general asset account are made pursuant to paragraph (h)(2)(ii) of this section, the taxpayer must establish a new general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the adjusted depreciable basis of the asset as of the first day of the year of change is included in the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under §1.168(i)–4(d)(3)(i).

(B) *Change in use results in a longer recovery period and/or a slower depreciation method.* If the result of the change in use is described in §1.168(i)–4(d)(4) (change in use results in a longer recovery period and/or a slower depreciation method), the taxpayer must establish a separate general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable basis of the asset, and the greater of the depreciation of the asset allowed or allowable in accordance with section 1016(a)(2), as of the first day of the year of change are included in the newly established general asset account. Consequently, this general asset account as of the first day of the year of change will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under §1.168(i)–4(d)(4)(ii).

* * * * *

(l) *Effective dates*—(1) [Reserved]. For further guidance, see §1.168(i)–1T(l)(1).

(2) *Exceptions*—(i) *In general*—(A) Paragraph (b)(1) of this section applies on or after June 17, 2004. For the applicability of §1.168(i)–1(b)(1) before June 17, 2004, see §1.168(i)–1(b)(1) in effect prior to June 17, 2004 (§1.168(i)–1(b)(1) as contained in 26 CFR part 1 edition revised as of April 1, 2004).

(B) Paragraphs (c)(2)(ii)(E) and (h)(2) of this section apply to any change in the use of depreciable assets pursuant to §1.168(i)–4(d) in a taxable year ending on or after June 17, 2004. For any change in the use of depreciable assets as described in §1.168(i)–4(d) after December 31, 1986, in a taxable year ending before June 17, 2004, the Internal Revenue Service will allow any reasonable method that is consistently applied to the taxpayer's general asset accounts or the taxpayer may choose, on an asset-by-asset basis, to apply paragraphs (c)(2)(ii)(E) and (h)(2) of this section.

(ii) *Change in method of accounting*—(A) *In general.* If a taxpayer adopted a method of accounting for general asset account treatment due to a change in the use of depreciable assets pursuant to §1.168(i)–4(d) in a taxable year ending on or after December 30, 2003, and the method adopted is not in accordance with the method of accounting provided in paragraphs (c)(2)(ii)(E) and (h)(2) of this section, a change to the method of accounting provided in paragraphs (c)(2)(ii)(E) and (h)(2) of this section is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. However, if a taxpayer adopted a method of accounting for general asset account treatment due to a change in the use of depreciable assets pursuant to §1.168(i)–4(d) after December 31, 1986, in a taxable year ending before December 30, 2003, and the method adopted is not in accordance with the method of accounting provided in paragraphs (c)(2)(ii)(E) and (h)(2) of this section, the taxpayer may treat the change to the method of accounting provided in paragraphs (c)(2)(ii)(E) and (h)(2) of this section as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

(B) *Automatic consent to change method of accounting.* A taxpayer changing its method of accounting in accordance with this paragraph (l)(2)(ii) must follow the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, see Rev. Proc. 2002–9, 2002–1 C.B. 327, as modified by Rev. Proc. 2004–11, 2004–3 I.R.B. 311 (see §601.601(d)(2)(ii)(*b*) of this chapter)). Because this change does not change the adjusted depreciable basis of the asset, the method change is made on a cut-off basis and, therefore, no adjustment under section 481(a) is required or allowed. For purposes of Form 3115, *Application for Change in Accounting Method*, the designated number for the automatic accounting method change authorized by this paragraph (l)(2)(ii) is "87." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form.

(3) [Reserved]. For further guidance, see §1.168(i)–1T(l)(3).

Par. 4. Section 1.168(i)–1T is amended by:

1. Revising paragraphs (c)(2)(ii)(E) and (l)(2).

2. Removing the language "(h)(1) (conversion to personal use)" from paragraphs (d)(2) and (i) and adding "(h) (changes in use)" in its place.

3. Removing the language "(h)(1)" from paragraph (j) and adding "(h)" in its place.

The revisions read as follows:

§1.168(i)–1T General asset accounts (temporary).

* * * * *

(c) * * *

(2) * * *

(ii) * * *

(E) [Reserved]. For further guidance, see §1.168(i)–1(c)(2)(ii)(E).

* * * * *

(l) * * *

(2) [Reserved]. For further guidance, see §1.168(i)–1(l)(2).

* * * * *

Par. 5. Section 1.168(i)–4 is added to read as follows:

§1.168(i)–4 Changes in use.

(a) *Scope*. This section provides the rules for determining the depreciation allowance for MACRS property (as defined in §1.168(b)–1T(a)(2)) for which the use changes in the hands of the same taxpayer (change in the use). The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of change and any subsequent taxable year. For purposes of this section, the year of change is the taxable year in which a change in the use occurs.

(b) *Conversion to business or income-producing use*—(1) *Depreciation deduction allowable*. This paragraph (b) applies to property that is converted from personal use to use in a taxpayer's trade or business, or for the production of income, during a taxable year. This conversion includes property that was previously used by the taxpayer for personal purposes, including real property (other than land) that is acquired before 1987 and converted from personal use to business or income-producing use after 1986, and depreciable property that was previously used by a tax-exempt entity before the entity changed to a taxable entity. Except as otherwise provided by the Internal Revenue Code or regulations under the Internal Revenue Code, upon a conversion to business or income-producing use, the depreciation allowance for the year of change and any subsequent taxable year is determined as though the property is placed in service by the taxpayer on the date on which the conversion occurs. Thus, except as otherwise provided by the Internal Revenue Code or regulations under the Internal Revenue Code, the taxpayer must use any applicable depreciation method, recovery period, and convention prescribed under section 168 for the property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). See §§1.168(k)–1T(f)(6)(iii) and 1.1400L(b)–1T(f)(6) for the additional first year depreciation deduction rules applicable to a conversion to business or income-producing use. The depreciable basis of the property for the year of change is the lesser of its fair market value or its adjusted depreciable basis (as defined in §1.168(b)–1T(a)(4)), as applicable, at the time of the conversion to business or income-producing use.

(2) *Example*. The application of this paragraph (b) is illustrated by the following example:

Example. *A*, a calendar-year taxpayer, purchases a house in 1985 that she occupies as her principal residence. In February 2004, *A* ceases to occupy the house and converts it to residential rental property. At the time of the conversion to residential rental property, the house's fair market value (excluding land) is $130,000 and adjusted depreciable basis attributable to the house (excluding land) is $150,000. Pursuant to this paragraph (b), *A* is considered to have placed in service residential rental property in February 2004 with a depreciable basis of $130,000. *A* depreciates the residential rental property under the general depreciation system by using the straight-line method, a 27.5-year recovery period, and the mid-month convention. Pursuant to §§1.168(k)–1T(f)(6)(iii)(B) or 1.1400L(b)–1T(f)(6), this property is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, the depreciation allowance for the house for 2004 is $4,137, after taking into account the mid-month convention (($130,000 adjusted depreciable basis multiplied by the applicable depreciation rate of 3.636% (1/27.5)) multiplied by the mid-month convention fraction of 10.5/12). The amount of depreciation computed under section 168, however, may be limited under other provisions of the Internal Revenue Code, such as, section 280A.

(c) *Conversion to personal use*. The conversion of MACRS property from business or income-producing use to personal use during a taxable year is treated as a disposition of the property in that taxable year. The depreciation allowance for MACRS property for the year of change in which the property is treated as being disposed of is determined by first multiplying the adjusted depreciable basis of the property as of the first day of the year of change by the applicable depreciation rate for that taxable year (for further guidance, for example, see section 6 of Rev. Proc. 87–57, 1987–2 C. B. 687, 692 (see §601.601(d)(2)(ii)(*b*) of this chapter)). This amount is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of change (taking into account the applicable convention) and the denominator of which is 12. No depreciation deduction is allowable for MACRS property placed in service and disposed of in the same taxable year. See §§1.168(k)–1T(f)(6)(ii) and 1.1400L(b)–1T(f)(6) for the additional first year depreciation deduction rules applicable to property placed in service and converted to personal use in the same taxable year. Upon the conversion to personal use, no gain, loss, or depreciation recapture under section 1245 or section 1250 is recognized. However, the provisions of section 1245 or section 1250 apply to any disposition of the converted property by the taxpayer at a later date. For listed property (as defined in section 280F(d)(4)), see section 280F(b)(2) for the recapture of excess depreciation upon the conversion to personal use.

(d) *Change in the use results in a different recovery period and/or depreciation method*—(1) *In general*. This paragraph (d) applies to a change in the use of MACRS property during a taxable year subsequent to the placed-in-service year, if the property continues to be MACRS property owned by the same taxpayer and, as a result of the change in the use, has a different recovery period, a different depreciation method, or both. For example, this paragraph (d) applies to MACRS property that—

(i) Begins or ceases to be used predominantly outside the United States;

(ii) Results in a reclassification of the property under section 168(e) due to a change in the use of the property; or

(iii) Begins or ceases to be tax-exempt use property (as defined in section 168(h)).

(2) *Determination of change in the use*—(i) *In general*. Except as provided in paragraph (d)(2)(ii) of this section, a change in the use of MACRS property occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. The primary use of MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property.

(ii) *Alternative depreciation system property*—(A) *Property used within or outside the United States*. A change in the use of MACRS property occurs when a taxpayer begins or ceases to use MACRS property predominantly outside the United States during the taxable year. The determination of whether MACRS property is used predominantly outside the United States is made in accordance with the test in §1.48–1(g)(1)(i) for determining predominant use.

(B) *Tax-exempt bond financed property*. A change in the use of MACRS property occurs when the property changes to tax-exempt bond financed property, as described in section 168(g)(1)(C) and (g)(5), during the taxable year. For purposes of this paragraph (d), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is no longer outstanding or is redeemed.

(C) *Other mandatory alternative depreciation system property*. A change in the use of MACRS property occurs when the property changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive order) during the taxable year.

(iii) *Change in the use deemed to occur on first day of the year of change*. If a change in the use of MACRS property occurs under this paragraph (d)(2), the depreciation allowance for that MACRS property for the year of change is determined as though the use of the MACRS property changed on the first day of the year of change.

(3) *Change in the use results in a shorter recovery period and/or a more accelerated depreciation method*—(i) *Treated as placed in service in the year of change*—(A) *In general*. If a change in the use results in the MACRS property changing to a shorter recovery period and/or a depreciation method that is more accelerated than the method used for the MACRS property before the change in the use, the depreciation allowances beginning in the year of change are determined as though the MACRS property is placed in service by the taxpayer in the year of change.

(B) *Computation of depreciation allowance*. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year. In determining the applicable depreciation rate for the year of change and subsequent taxable years, the taxpayer must use any applicable depreciation method and recovery period prescribed under section 168 for the MACRS property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. However, the depreciation allowance for the year of change for the MACRS property is determined without applying the applicable convention, unless the MACRS property is disposed of during the year of change. See paragraph (d)(5) of this section for the rules relating to the computation of the depreciation allowance under the optional depreciation tables. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(3)(i) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816 (see §601.601(d)(2)(ii)(*b*) of this chapter)).

(C) *Special rules*. MACRS property affected by this paragraph (d)(3)(i) is not eligible in the year of change for the election provided under section 168(f)(1), 179, or 1400L(f), or for the additional first year depreciation deduction provided in section 168(k) or 1400L(b). See §§1.168(k)–1T(f)(6)(iv) and 1.1400L(b)–1T(f)(6) for other additional first year depreciation deduction rules applicable to a change in the use of MACRS property subsequent to its placed-in-service year. For purposes of determining whether the mid-quarter convention applies to other MACRS property placed in service during the year of change, the unadjusted depreciable basis (as defined in §1.168(b)–1T(a)(3)) or the adjusted depreciable basis of MACRS property affected by this paragraph (d)(3)(i) is not taken into account.

(ii) *Option to disregard the change in the use*. In lieu of applying paragraph (d)(3)(i) of this section, the taxpayer may elect to determine the depreciation allowance as though the change in the use had not occurred. The taxpayer elects this option by claiming on the taxpayer's timely filed (including extensions) Federal income tax return for the year of change the depreciation allowance for the property as though the change in the use had not occurred. See paragraph (g)(2) of this section for the manner for revoking this election.

(4) *Change in the use results in a longer recovery period and/or a slower depreciation method*—(i) *Treated as originally placed in service with longer recovery period and/or slower depreciation method*. If a change in the use results in a longer recovery period and/or a depreciation method for the MACRS property that is less accelerated than the method used for the MACRS property before the change in the use, the depreciation allowances beginning with the year of change are determined as though the MACRS property had been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method. MACRS property affected by this paragraph (d)(4) is not eligible in the year of change for the election provided under section 168(f)(1), 179, or 1400L(f), or for the additional first year depreciation deduction provided in section 168(k) or 1400L(b). See §§1.168(k)–1T(f)(6)(iv) and 1.1400L(b)–1T(f)(6) for other additional first year depreciation deduction rules applicable to a change in the use of MACRS property subsequent to its placed-in-service year.

(ii) *Computation of the depreciation allowance*. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year. If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(4)(ii) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816 (see §601.601(d)(2)(ii)(*b*) of this chapter)). See paragraph (d)(5) of this section for the rules relating to the computation of the depreciation allowance under the optional depreciation tables. In determining the applicable depreciation rate for the year of change and any subsequent taxable year—

(A) The applicable depreciation method is the depreciation method that would apply in the year of change and any subsequent taxable year for the MACRS property had the taxpayer used the longer recovery period and/or the slower depreciation method in the placed-in-service year of the property. If the 200- or 150-percent declining balance method would have applied in the placed-in-service year but the method would have switched to the straight line method in the year of change or any prior taxable year, the applicable depreciation method beginning with the year of change is the straight line method; and

(B) The applicable recovery period is either—

(*1*) The longer recovery period resulting from the change in the use if the applicable depreciation method is the 200- or 150-percent declining balance method (as determined under paragraph (d)(4)(ii)(A) of this section) unless the recovery period did not change as a result of the change in the use, in which case the applicable recovery period is the same recovery period that applied before the change in the use; or

(*2*) The number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) had the taxpayer used the longer recovery period in the placed-in-service year of the property if the applicable depreciation method is the straight line method (as determined under paragraph (d)(4)(ii)(A) of this section) unless the recovery period did not change as a result of the change in the use, in which case the applicable recovery period is the number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) based on the recovery period that applied before the change in the use.

(5) *Using optional depreciation tables*—(i) *Taxpayer not bound by prior use of table*. If a taxpayer used an optional depreciation table for the MACRS property before a change in the use, the taxpayer is not bound to use the appropriate new table for that MACRS property beginning in the year of change (for further guidance, for example, see section 8 of Rev. Proc. 87–57, 1987–2 C.B. 687, 693 (see §601.601(d)(2)(ii)(*b*) of this chapter)). If a taxpayer did not use an optional depreciation table for MACRS property before a change in the use and the change in the use results in a shorter recovery period and/or a more accelerated depreciation method (as described in paragraph (d)(3)(i) of this section), the taxpayer may use the appropriate new table for that MACRS property beginning in the year of change. If a taxpayer chooses not to use the optional depreciation table, the depreciation allowances for the MACRS property beginning in the year of change are determined under paragraph (d)(3)(i) or (4) of this section, as applicable.

(ii) *Taxpayer chooses to use optional depreciation table after a change in the use*. If a taxpayer chooses to use an optional depreciation table for the MACRS property after a change in the use, the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined as follows:

(A) *Change in the use results in a shorter recovery period and/or a more accelerated depreciation method*. If a change in the use results in a shorter recovery period and/or a more accelerated depreciation method (as described in paragraph (d)(3)(i) of this section), the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of the year of change by the annual depreciation rate for each recovery year (expressed as a decimal equivalent) specified in the appropriate optional depreciation table. The appropriate optional depreciation table for the MACRS property is based on the depreciation system, depreciation method, recovery period, and convention applicable to the MACRS property in the year of change as determined under paragraph (d)(3)(i) of this section. The depreciation allowance for the year of change for the MACRS property is determined by taking into account the applicable convention (which is already factored into the optional depreciation tables). If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(5)(ii)(A) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816 (see §601.601(d)(2)(ii)(*b*) of this chapter)).

(B) *Change in the use results in a longer recovery period and/or a slower depreciation method*—(*1*) *Determination of the appropriate optional depreciation table*. If a change in the use results in a longer recovery period and/or a slower depreciation method (as described in paragraph (d)(4)(i) of this section), the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by choosing the optional depreciation table that corresponds to the depreciation system, depreciation method, recovery period, and convention that would have applied to the MACRS property in the placed-in-service year had that property been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method. If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(5)(ii)(B) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816 (see §601.601(d)(2)(ii)(*b*) of this chapter)).

(*2*) *Computation of the depreciation allowance*. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are computed by first determining the appropriate recovery year in the table identified under paragraph (d)(5)(ii)(B)(*1*) of this section. The appropriate recovery year for the year of change is the year that corresponds to the year of change. For example, if the recovery year for the year of change would have been Year 4 in the table that applied before the change in the use of the MACRS property, then the recovery year for the year of change is Year 4 in the table identified under paragraph (d)(5)(ii)(B)(*1*) of this section. Next, the annual depreciation rate (expressed as a decimal equivalent) for each recovery year is multiplied by a transaction coefficient. The transaction coefficient is the formula (1 / (1 - x)) where x equals the sum of the annual depreciation rates from the table identified under paragraph (d)(5)(ii)(B)(*1*) of this section (expressed as a decimal equivalent) for the taxable years beginning with the placed-in-service year of the MACRS property through the taxable year immediately prior to the year of change. The product of the annual depreciation rate and the transaction coefficient is multiplied by the adjusted depreciable basis of the MACRS property as of the beginning of the year of change.

(6) *Examples*. The application of this paragraph (d) is illustrated by the following examples:

Example 1. Change in the use results in a shorter recovery period and/or a more accelerated depreciation method and optional depreciation table is not used—(i) *X*, a calendar-year corporation, places in service in 1999 equipment at a cost of $100,000 and uses this equipment from 1999 through 2003 primarily in its *A* business. *X* depreciates the equipment for 1999 through 2003 under the general depreciation system as 7-year property by using the 200-percent declining balance method (which switched to the straight-line method in 2003), a 7-year recovery period, and a half-year convention. Beginning in 2004, *X* primarily uses the equipment in its *B* business. As a result, the classification of the equipment under section 168(e) changes from 7-year property to 5-year property and the recovery period of the equipment under the general depreciation system changes from 7 years to 5 years. The depreciation method does not change. On January 1, 2004, the adjusted depreciable basis of the equipment is $22,311. *X* depreciates its 5-year recovery property placed in service in 2004 under the general depreciation system by using the 200-percent declining balance method and a 5-year recovery period. *X* does not use the optional depreciation tables.

(ii) Under paragraph (d)(3)(i) of this section, *X*'s allowable depreciation deduction for the equipment for 2004 and subsequent taxable years is determined as though *X* placed the equipment in service in 2004 for use primarily in its *B* business. The depreciable basis of the equipment as of January 1, 2004, is $22,311 (the adjusted depreciable basis at January 1, 2004). Because *X* does not use the optional depreciation tables, the depreciation allowance for 2004 (the deemed placed-in-service year) for this equipment only is computed without taking into account the half-year convention. Pursuant to paragraph (d)(3)(i)(C) of this section, this equipment is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, *X*'s allowable depreciation deduction for the equipment for 2004 is $8,924 ($22,311 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 40% (200/5)). *X*'s allowable depreciation deduction for the equipment for 2005 is $5,355 ($13,387 adjusted depreciable basis at January 1, 2005, multiplied by the applicable depreciation rate of 40% (200/5)).

(iii) Alternatively, under paragraph (d)(3)(ii) of this section, *X* may elect to disregard the change in the use and, as a result, may continue to treat the equipment as though it is used primarily in its *A* business. If the election is made, *X*'s allowable depreciation deduction for the equipment for 2004 is $8,924 ($22,311 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 40% (1/2.5 years remaining at January 1, 2004)). *X*'s allowable depreciation deduction for the equipment for 2005 is $8,925 ($13,387 adjusted depreciable basis at January 1, 2005, multiplied by the applicable depreciation rate of 66.67% (1/1.5 years remaining at January 1, 2005)).

Example 2. Change in the use results in a shorter recovery period and/or a more accelerated depreciation method and optional depreciation table is used—(i) Same facts as in *Example 1*, except that *X* used the optional depreciation tables for computing depreciation for 1999 through 2003. Pursuant to paragraph (d)(5) of this section, *X* chooses to continue to use the optional depreciation table for the equipment. *X* does not make the election provided in paragraph (d)(3)(ii) of this section to disregard the change in use.

(ii) In accordance with paragraph (d)(5)(ii)(A) of this section, *X* must first identify the appropriate optional depreciation table for the equipment. This table is table 1 in Rev. Proc. 87–57 because the equipment will be depreciated in the year of change (2004) under the general depreciation system using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention (which is the convention that applied to the equipment in 1999). Pursuant to paragraph (d)(3)(i)(C) of this section, this equipment is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). For 2004, *X* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $22,311, by the annual depreciation rate in table 1 for recovery year 1 for a 5-year recovery period (.20), to determine the depreciation allowance of $4,462. For 2005, *X* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $22,311, by the annual depreciation rate in table 1 for recovery year 2 for a 5-year recovery period (.32), to determine the depreciation allowance of $7,140.

Example 3. Change in the use results in a longer recovery period and/or a slower depreciation method—(i) *Y*, a calendar-year corporation, places in service in January 2002, equipment at a cost of $100,000 and uses this equipment in 2002 and 2003 only within the United States. *Y* elects not to deduct the additional first year depreciation under section 168(k). *Y* depreciates the equipment for 2002 and 2003 under the general depreciation system by using the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. Beginning in 2004, *Y* uses the equipment predominantly outside the United States. As a result of this change in the use, the equipment is subject to the alternative depreciation system beginning in 2004. Under the alternative depreciation system, the equipment is depreciated by using the straight line method and a 9-year recovery period. The adjusted depreciable basis of the equipment at January 1, 2004, is $48,000.

(ii) Pursuant to paragraph (d)(4) of this section, *Y*'s allowable depreciation deduction for 2004 and subsequent taxable years is determined as though the equipment had been placed in service in January 2002, as property used predominantly outside the United States. Further, pursuant to paragraph (d)(4)(i) of this section, the equipment is not eligible in 2004 for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). In determining the applicable depreciation rate for 2004, the applicable depreciation method is the straight line method and the applicable recovery period is 7.5 years, which is the number of years remaining at January 1, 2004, for property placed in service in 2002 with a 9-year recovery period (taking into account the half-year convention). Thus, the depreciation allowance for 2004 is $6,398 ($48,000 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 13.33% (1/7.5 years)). The depreciation allowance for 2005 is $6,398 ($41,602 adjusted depreciable basis at January 1, 2005, multiplied by the applicable depreciation rate of 15.38% (1/6.5 years remaining at January 1, 2005)).

Example 4. Change in the use results in a longer recovery period and/or a slower depreciation method and optional depreciation table is used—(i) Same facts as in *Example 3*, except that *Y* used the optional depreciation tables for computing depreciation in 2002 and 2003. Pursuant to paragraph (d)(5) of this section, *Y* chooses to continue to use the optional depreciation table for the equipment. Further, pursuant to paragraph (d)(4)(i) of this section, the equipment is not eligible in 2004 for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b).

(ii) In accordance with paragraph (d)(5)(ii)(B) of this section, *Y* must first determine the appropriate optional depreciation table for the equipment pursuant to paragraph (d)(5)(ii)(B)(*1*) of this section. This table is table 8 in Rev. Proc. 87–57, which corresponds to the alternative depreciation system, the straight line method, a 9-year recovery period, and the half-year convention (because *Y* depreciated 5-year property in 2002 using a half-year convention). Next, *Y* must determine the appropriate recovery year in table 8. Because the year of change is 2004, the depreciation allowance for the equipment for 2004 is determined using recovery year 3 of table 8. For 2004, *Y* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $48,000, by the product of the annual depreciation rate in table 8 for recovery year 3 for a 9-year recovery period (.1111) and the transaction coefficient of 1.200 [1/(1–(.0556 (table 8 for recovery year 1 for a 9-year recovery period) +.1111 (table 8 for recovery year 2 for a 9-year recovery period)))], to determine the depreciation allowance of $6,399. For 2005, *Y* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $48,000, by the product of the annual depreciation rate in table 8 for recovery year 4 for a 9-year recovery period (.1111) and the transaction coefficient (1.200), to determine the depreciation allowance of $6,399.

(e) *Change in the use of MACRS property during the placed-in-service year*—(1) *In general*. Except as provided in paragraph (e)(2) of this section, if a change in the use of MACRS property occurs during the placed-in-service year and the property continues to be MACRS property owned by the same taxpayer, the depreciation allowance for that property for the placed-in-service year is determined by its primary use during that year. The primary use of MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property. For purposes of this paragraph (e), the determination of whether the mid-quarter convention applies to any MACRS property placed in service during the year of change is made in accordance with §1.168(d)–1.

(2) *Alternative depreciation system property*—(i) *Property used within and outside the United States*. The depreciation allowance for the placed-in-service year for MACRS property that is used within and outside the United States is determined by its predominant use during that year. The determination of whether MACRS property is used predominantly outside the United States during the placed-in-service year shall be made in accordance with the test in §1.48–1(g)(1)(i) for determining predominant use.

(ii) *Tax-exempt bond financed property*. The depreciation allowance for the placed-in-service year for MACRS property that changes to tax-exempt bond financed property, as described in section 168(g)(1)(C) and (g)(5), during that taxable year is determined under the alternative depreciation system. For purposes of this paragraph (e), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is not outstanding at, or is redeemed by, the end of the placed-in-service year.

(iii) *Other mandatory alternative depreciation system property*. The depreciation allowance for the placed-in-service year for MACRS property that changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive order) during that taxable year is determined under—

(A) The alternative depreciation system if the MACRS property is described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year; or

(B) The general depreciation system if the MACRS property is not described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year, unless other provisions of the Internal Revenue Code or regulations under the Internal Revenue Code require the depreciation allowance for that MACRS property to be determined under the alternative depreciation system (for example, section 168(g)(7)).

(3) *Examples*. The application of this paragraph (e) is illustrated by the following examples:

Example 1. (i) *Z*, a utility and calendar-year corporation, acquires and places in service on January 1, 2004, equipment at a cost of $100,000. *Z* uses this equipment in its combustion turbine production plant for 4 months and then uses the equipment in its steam production plant for the remainder of 2004. *Z*'s combustion turbine production plant assets are classified as 15-year property and are depreciated by *Z* under the general depreciation system using a 15-year recovery period and the 150-percent declining balance method of depreciation. *Z*'s steam production plant assets are classified as 20-year property and are depreciated by *Z* under the general depreciation system using a 20-year recovery period and the 150-percent declining balance method of depreciation. *Z* uses the optional depreciation tables. The equipment is 50-percent bonus depreciation property for purposes of section 168(k).

(ii) Pursuant to this paragraph (e), *Z* must determine depreciation based on the primary use of the equipment during the placed-in-service year. *Z* has consistently determined the primary use of all of its MACRS properties by comparing the number of full months in the taxable year during which a MACRS property is used in one manner with the number of full months in that taxable year during which that MACRS property is used in another manner. Applying this approach, *Z* determines the depreciation allowance for the equipment for 2004 is based on the equipment being classified as 20-year property because the equipment was used by *Z* in its steam production plant for 8 months in 2004. If the half-year convention applies in 2004, the appropriate optional depreciation table is table 1 in Rev. Proc. 87–57, which is the table for MACRS property subject to the general depreciation system, the 150-percent declining balance method, a 20-year recovery period, and the half-year convention. Thus, the depreciation allowance for the equipment for 2004 is $51,875, which is the total of $50,000 for the 50-percent additional first year depreciation deduction allowable (the unadjusted depreciable basis of $100,000 multiplied by .50), plus $1,875 for the 2004 depreciation allowance on the remaining adjusted depreciable basis of $50,000 [(the unadjusted depreciable basis of $100,000 less the additional first year depreciation deduction of $50,000) multiplied by the annual depreciation rate of .0375 in table 1 for recovery year 1 for a 20-year recovery period].

Example 2. *T*, a calendar year corporation, places in service on January 1, 2004, several computers at a total cost of $100,000. *T* uses these computers within the United States for 3 months in 2004 and then moves and uses the computers outside the United States for the remainder of 2004. Pursuant to §1.48–1(g)(1)(i), the computers are considered as used predominantly outside the United States in 2004. As a result, for 2004, the computers are required to be depreciated under the alternative depreciation system of section 168(g) with a recovery period of 5 years pursuant to section 168(g)(3)(C). *T* uses the optional depreciation tables. If the half-year convention applies in 2004, the appropriate optional depreciation table is table 8 in Rev. Proc. 87–57, which is the table for MACRS property subject to the alternative depreciation system, the straight line method, a 5-year recovery period, and the half-year convention. Thus, the depreciation allowance for the computers for 2004 is $10,000, which is equal to the unadjusted depreciable basis of $100,000 multiplied by the annual depreciation rate of .10 in table 8 for recovery year 1 for a 5-year recovery period. Because the computers are required to be depreciated under the alternative depreciation system in their placed-in-service year, pursuant to section 168(k)(2)(C)(i) and §1.168(k)–1T(b)(2)(ii), the computers are not eligible for the additional first year depreciation deduction provided by section 168(k).

(f) *No change in accounting method*. A change in computing the depreciation allowance in the year of change for property subject to this section is not a change in method of accounting under section 446(e). See §1.446–1T(e)(2)(ii)(*d*)(*3*)(*ii*).

(g) *Effective dates*—(1) *In general*. This section applies to any change in the use of MACRS property in a taxable year ending on or after June 17, 2004. For any change in the use of MACRS property after December 31, 1986, in a taxable year ending before June 17, 2004, the Internal Revenue Service will allow any reasonable method of depreciating the property under section 168 in the year of change and the subsequent taxable years that is consistently applied to any property for which the use changes in the hands of the same taxpayer or the taxpayer may choose, on a property-by-property basis, to apply the provisions of this section.

(2) *Change in method of accounting*—(i) *In general*. If a taxpayer adopted a method of accounting for depreciation due to a change in the use of MACRS property in a taxable year ending on or after December 30, 2003, and the method adopted is not in accordance with the method of accounting for depreciation provided in this section, a change to the method of accounting for depreciation provided in this section is a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations under sections 446(e) and 481 apply. Also, a revocation of the election provided in paragraph (d)(3)(ii) of this section to disregard a change in the use is a change in method of accounting to

which the provisions of sections 446(e) and 481 and the regulations under sections 446(e) and 481 apply. However, if a taxpayer adopted a method of accounting for depreciation due to a change in the use of MACRS property after December 31, 1986, in a taxable year ending before December 30, 2003, and the method adopted is not in accordance with the method of accounting for depreciation provided in this section, the taxpayer may treat the change to the method of accounting for depreciation provided in this section as a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations under sections 446(e) and 481 apply.

(ii) *Automatic consent to change method of accounting.* A taxpayer changing its method of accounting in accordance with this paragraph (g)(2) must follow the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, see Rev. Proc. 2002–9, 2002–1 C.B. 327, as modified by Rev. Proc. 2004–11, 2004–3 I.R.B. 311 (see §601.601(d)(2)(ii)(*b*) of this chapter)). Any change in method of accounting made under this paragraph (g)(2) must be made using an adjustment under section 481(a). For purposes of Form 3115, *Application for Change in Accounting Method*, the designated number for the automatic accounting method change authorized by this paragraph (g)(2) is "88." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved June 7, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on June 16, 2004, 8:45 a.m., and published in the issue of the Federal Register for June 17, 2004, 69 F.R. 33840)

Section 280F.—Limitation on Depreciation for Luxury Automobiles; Limitation Where Certain Property Used for Personal Purposes

26 CFR 1.280F–1T: Limitations on investment tax credit and recovery deductions under section 168 for passenger automobiles and certain other listed property; overview of regulations (temporary).

T.D. 9133

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Depreciation of Vans and Light Trucks

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the definition of passenger automobile for purposes of the dollar limits on depreciation deductions for passenger automobiles. These regulations affect certain taxpayers that use vans and light trucks in their trade or business.

DATES: *Effective Date*: These regulations are effective June 25, 2004.

Applicability Dates: These regulations apply to property placed in service by a taxpayer on or after July 7, 2003. For regulations applicable to property placed in service before July 7, 2003, see §1.280F–6T as in effect prior to July 7, 2003 (§1.280F–6T as contained in 26 CFR part 1, revised as of April 1, 2003). Taxpayers may choose to apply §1.280F–6(c)(3)(iii) to property placed in service prior to July 7, 2003, and if necessary may either amend returns for open taxable years or file a Form 3115 in order to apply §1.280F–6(c)(3)(iii) to such property.

FOR FURTHER INFORMATION CONTACT: Bernard P. Harvey, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On July 7, 2003, the IRS published temporary regulations (T.D. 9069, 2003–37 I.R.B. 525) in the **Federal Register** (68 FR 40129) containing amendments to 26 CFR part 1 under section 280F of the Internal Revenue Code of 1986 (Code), including the addition of §1.280F–6T(c)(3)(iii). On the same date, the IRS published proposed regulations (REG–138495–02, 2003–37 I.R.B. 541) in the **Federal Register** (68 FR 40224) inviting comments under section 280F and inviting requests to hold a public hearing. Several comments were received, but no requests to hold a public hearing. After consideration of all the comments, the rules in T.D. 9069 and the proposed regulations are made retroactive for taxpayers that choose to apply the rules to property placed in service before the proposed effective date and are adopted as final regulations. In addition, a conforming amendment is made to §1.280F–6T, and §1.280F–6T is redesignated as §1.280F–6.

Explanation of Provisions

Section 280F(a) of the Code imposes annual dollar limits on the depreciation deduction allowable with respect to passenger automobiles. T.D. 9069 and the proposed regulations provide that a truck or van is not subject to these limits if it is a *qualified nonpersonal use vehicle* as defined in §1.274–5T(k). This rule applies to vehicles placed in service on or after July 7, 2003.

Commentators suggested that the rule announced by T.D. 9069 and the proposed regulations be made available retroactively to owners of qualified nonpersonal use vehicles placed in service during the period beginning January 1, 2003, and ending July 6, 2003, and that taxpayers who have filed fiscal-year returns be allowed to amend those returns to claim additional deductions for such vehicles. Commentators have also requested that we give some measure of audit protection to taxpayers who placed qualified nonpersonal use vehicles in service prior to 2003 and depreciated the vehicles in a manner consistent with T.D. 9069 and the proposed regulations. We have amended the effective date provision to allow taxpayers to use the exclusion for qualified nonpersonal use vehicles for vehicles placed in service prior to July 7, 2003, and to permit taxpayers either to amend tax returns for open taxable years, or to treat the change as a change in method of accounting by filing a Form 3115, "*Application for Change in Accounting Method*".

Comments received from the funeral services industry requested amendments to the definition of *qualified nonpersonal use vehicles* in the temporary regulations under section 274 to clarify that certain vehicles used in the funeral services industry are qualified nonpersonal use vehicles for purposes of the substantiation requirements under that section. We believe that such an amendment is beyond the scope of these regulations, which are specific to section 280F(a).

Another commentator indicated that the relief afforded by T.D. 9069 and the proposed regulations is too narrow, and requested that we amend the regulations to establish a use-based test that would exclude more trucks and vans from section 280F(a). The comment suggested a test that would exclude all trucks and vans for which the taxpayer could demonstrate a specific business need, and which are used for a valid business purpose. We believe that the proposed test is inherently subjective and would cause administrative difficulty of the type that the proposed regulations were designed to avoid. We continue to encourage suggestions for objective use-based tests that could serve as the basis for future guidance.

We were asked by the Office of Advocacy of the U.S. Small Business Administration (Advocacy) to perform a regulatory flexibility analysis because Advocacy believes that T.D. 9069 and the proposed regulations constitute a legislative rule as defined in the Regulatory Flexibility Act. A Regulatory Flexibility Act (RFA) analysis must be performed for legislative rules having a significant impact on small business, but not for interpretive rules or for legislative rules with no significant impact on small businesses. It is the position of the IRS and Treasury that T.D. 9069 and the proposed regulations constitute an interpretive rule for which no regulatory flexibility analysis is necessary. In any event, the rule proposed in the regulations is in all cases beneficial to taxpayers and does not have a significant impact on small business for purposes of the Regulatory Flexibility Act.

Special Analyses

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

Drafting Information

The principal author of these regulations is Bernard P. Harvey, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended by adopting the rules of section 1.280F–6T as final regulations, by making conforming amendments to sections 1.280F–1T through 1.280F–7, and by updating the authority citation as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "Section 1.280F–6T" and adding an entry in numerical order to read as follows:

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

Section 1.280F–6 also issued under 26 U.S.C. 280F. * * *

§1.280F–1T [Amended]

Par. 2 Section 1.280F–1T is amended as follows:

1. The heading in the fifth column of the table of paragraph (b) is amended by removing "§1.280F–6T" and adding "§1.280F–6" in its place.

2. The first sentence in paragraph (c)(1) is amended by removing "1.280F–6T" and adding "1.280F–6" in its place.

3. The first sentence in paragraph (c)(2) is amended by removing "1.280F–6T" and adding "1.280F–6" in its place.

§1.280F–2T [Amended]

Par. 3 Section 1.280F–2T is amended as follows:

The first sentence in paragraph (i) is amended by removing "§1.280F–6T(d)(3)" and adding "§1.280F–6(d)(3)" in its place.

§1.280F–3T [Amended]

Par. 4 Section 1.280F–3T is amended as follows:

1. The first sentence in paragraph (a) is amended by removing "§1.280F–6T(b)" and adding "§1.280F–6(b)" in its place.

2. The last sentence in paragraph (a) is amended by removing "§1.280F–6T(d)" and adding "§1.280F–6(d)" in its place.

3. The first sentence in paragraph (b)(1) is amended by removing "§1.280F–6T(d)(1)" and adding "§1.280F–6(d)(1)" in its place.

4. The third sentence in paragraph (b)(1) is amended by removing "§1.280F–6T(d)(3)" and adding "§1.280F–6(d)(3)" in its place, and by removing "§1.280F–6T(d)(2)(i)" and adding "§1.280F–6(d)(2)(i)" in its place.

5. The first sentence in paragraph (b)(2) is amended by removing "§1.280F–6T(d)(3)" and adding "§1.280F–6(d)(3)" in its place.

6. The third sentence in paragraph (b)(2) is amended by removing "§1.280F–6T(d)(1)" and adding "§1.280F–6(d)(1)" in its place.

7. The first sentence in paragraph (c)(1) is amended by removing "§1.280F–6T(b)" and adding "§1.280F–6(b)" in its place, and by removing "§1.280F–6T(d)(4)" and adding "§1.280F–6(d)(4)" in its place.

8. The first sentence in paragraph (c)(2) is amended by removing "§1.280F–6T(d)(4)" and adding "§1.280F–6(d)(4)" in its place.

9. Paragraph (d)(1) is amended by removing "§1.280F–6T(d)(4)" and adding "§1.280F–6(d)(4)" in its place.

§1.280F–4T [Amended]

Par. 5 Section 1.280F–4T is amended as follows:

The fifth sentence in paragraph (a)(1) is amended by removing "§1.280F–6T(d)(2)" and adding "§1.280F–6(d)(2)" in its place.

§1.280F–5T [Amended]

Par. 6 Section 1.280F–5T is amended as follows:

The first sentence in paragraph (d)(1) is amended by removing "§1.280F–6T(d)(3)(i)" and adding "§1.280F–6(d)(3)(i)" in its place.

§1.280F–6T [Redesignated as §1.280F–6 and amended]

Par. 7 Section 1.280F–6T is redesignated as §1.280F–6 and the word "(temporary)" is removed from the section heading. Newly-designated §1.280F–6 is amended as follows:

1. Paragraph (b)(1)(iv) is amended by removing "section 168(j)(5)(D)" and adding "section 168(i)(2)(B)" in its place.
2. Paragraph (f) is added.

The addition reads as follows:

§1.280F–6 Special rules and definitions.

* * * * *

(f) *Effective date*—(1) *In general*. Except as provided in paragraph (f)(2) of this section, this section applies to property placed in service by a taxpayer on or after July 7, 2003. For regulations applicable to property placed in service before July 7, 2003, see §1.280F–6T as in effect prior to July 7, 2003 (§1.280F–6T as contained in 26 CFR part 1, revised as of April 1, 2003).

(2) *Property placed in service before July 7, 2003*. The following rules apply to property that is described in paragraph (c)(3)(iii) of this section, was placed in service by the taxpayer before July 7, 2003, and was treated by the taxpayer as a passenger automobile under §1.280F–6T as in effect prior to July 7, 2003 (pre-effective date vehicle):

(i) Except as provided in paragraphs (f)(2)(ii), (iii), and (iv) of this section, a pre-effective date vehicle will be treated as a passenger automobile to which section 280F(a) applies.

(ii) A pre-effective date vehicle will be treated as property to which section 280F(a) does not apply if the taxpayer adopts that treatment in determining depreciation deductions on the taxpayer's original return for the year in which the vehicle is placed in service.

(iii) A pre-effective date vehicle will be treated, to the extent provided in this paragraph (f)(2)(iii), as property to which section 280F(a) does not apply if the taxpayer adopts that treatment on an amended Federal tax return in accordance with this paragraph (f)(2)(iii). This paragraph (f)(2)(iii) applies only if, on or before December 31, 2004, the taxpayer files, for all applicable taxable years, amended Federal tax returns (or qualified amended returns, if applicable (for further guidance, see Rev. Proc. 94–69, 1994–2 C.B. 804, and §601.601(d)(2)(ii)(*b*) of this chapter)) treating the vehicle as property to which section 280F(a) does not apply. The applicable taxable years for this purpose are the taxable year in which the vehicle was placed in service by the taxpayer (or, if the period of limitation for assessment under section 6501 has expired for such year or any subsequent year (a closed year), the first taxable year following the most recent closed year) and all subsequent taxable years in which the vehicle was treated on the taxpayer's return as property to which section 280F(a) applies. If the earliest applicable taxable year is not the year in which the vehicle was placed in service, the adjusted depreciable basis of the property as of the beginning of the first applicable taxable year is recovered over the remaining recovery period. If the remaining recovery period as of the beginning of the first applicable taxable year is less than 12 months, the entire adjusted depreciable basis of the property as of the beginning of the first applicable taxable year is recovered in that year.

(iv) A pre-effective date vehicle will be treated, to the extent provided in this paragraph (f)(2)(iv), as property to which section 280F(a) does not apply if the taxpayer adopts that treatment on Form 3115, *Application for Change in Accounting Method*, in accordance with this paragraph (f)(2)(iv). The taxpayer must follow the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter). If the taxpayer files a Form 3115 treating the vehicle as property to which section 280F(a) does not apply, the taxpayer will be permitted to treat the change as a change in method of accounting under section 446(e) of the Internal Revenue Code and to take into account the section 481 adjustment resulting from the method change. For purposes of Form 3115, the designated number for the automatic accounting method change authorized for this paragraph (f)(2)(iv) is 89.

§1.280F–7 [Amended]

Par. 8 Section 1.280F–7 is amended as follows:

1. Paragraph (a)(2)(iii) is amended by removing "§1.280F–6T(d)(3)(i)" and adding "§1.280F–6(d)(3)(i)" in its place.
2. The second sentence in paragraph (b)(1) is amended by removing "§1.280F–6T(d)(1)" and adding "§1.280F–6(d)(1)" in its place.
3. Paragraph (b)(2)(i)(B) is amended by removing "§1.280F–6T(d)(3)(i)" and adding "§1.280F–6(d)(3)(i)" in its place, and by removing "§1.280F–6T(d)(1)" and adding "§1.280F–6(d)(1)" in its place.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved June 17, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 24, 2004, 8:45 a.m., and published in the issue of the Federal Register for June 25, 2004, 69 F.R. 35513)

Section 457.—Deferred Compensation Plans of State and Local Governments and Tax-Exempt Organizations

26 CFR 1.457–8: Funding rules for eligible plans.

Whether a governmental plan described in § 457(b) of the Code may invest in a group trust. See Rev. Rul. 2004-67, page 28.

Section 501.—Exemption From Tax on Corporations, Certain Trusts, etc.

26 CFR 1.501(a)–1: Exemption from taxation. (Also, §§ 457; 1.457–8.)

Group or pooled trusts; participation; tax-exempt status, model language. This ruling provides that a governmental section 457(b) plan may invest in a second tier group or pooled trust as long as the criteria enumerated in the ruling are met. In addition, the ruling sets forth model language that may be adopted by existing group or pooled trusts so that they need not request determination letters merely to add a provision permitting participation by a governmental section 457(b) plan. Rev. Rul. 81–100 clarified and modified.

Rev. Rul. 2004–67

PURPOSE

This revenue ruling extends the ability to participate in group trusts described in Rev. Rul. 81–100, 1981–1 C.B. 326, to eligible governmental plans under § 457(b) of the Internal Revenue Code and clarifies the ability of Roth individual retirement accounts described in § 408A and deemed individual retirement accounts described in § 408(q) to participate in these group trusts. In addition, this revenue ruling provides related model language for eligible governmental plans under § 457(b).

ISSUE

Whether the assets of eligible governmental plan trusts described in § 457(b) may be pooled with the assets of a group trust described in Rev. Rul. 81–100, without affecting the tax status of the eligible governmental plan trust or the group trust (including its current participants).

LAW AND ANALYSIS

Section 501(a) provides, in part, that a trust described in § 401(a) is exempt from income tax.

Section 401(a)(1) provides that a trust or trusts created or organized in the United States and forming a part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries is qualified under § 401(a) if contributions are made to the trust or trusts by the applicable employer, or employees, or both for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated in accordance with such plan. Section 401(a)(2) provides, in part, that under each trust instrument it must be impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the plan and the trust or trusts, for any part of the corpus or income of the trust, to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.

Section 401(a)(24) provides that any group trust that otherwise meets the requirements of § 401(a) will not fail to satisfy such requirements due to the participation or inclusion of a plan or governmental unit described in § 818(a)(6) in the group trust. Section 818(a)(6) provides, in part, that for these purposes the trust of a pension plan contract includes a governmental plan within the meaning of § 414(d) and an eligible deferred compensation plan within the meaning of § 457(b).

Section 401(f) provides that a custodial account, an annuity contract and certain other contracts issued by an insurance company will be treated as a qualified trust if the custodial account or contract would, except for the fact that it is not a trust, constitute a qualified trust under § 401, and, if the assets in any such custodial account are held by a bank or another person who demonstrates that he will hold the assets in a manner consistent with the requirements of § 401.

Section 408(e) provides for the exemption from taxation of an individual retirement account that meets the requirements of § 408. Section 408(a)(5) provides that the assets of an individual retirement account may not be commingled with other property except in a common trust fund or common investment fund.

Section 408A provides that, except as otherwise provided in § 408A, a Roth IRA is treated for purposes of the Code as an individual retirement plan, which includes an individual retirement account that meets the requirement of § 408. Consequently, a Roth IRA that is an individual retirement account is exempt from tax under § 408(e).

Section 408(q) provides, in part, that if a qualified employer plan, as defined in § 408(q)(3)(A), elects to allow employees to make voluntary employee contributions to a separate account established under the plan and, under the terms of the qualified employer plan, the account meets the requirements of § 408 or 408A for an individual retirement account, then that account is treated as an individual retirement account (deemed individual retirement account), and not as a qualified employer plan. An individual retirement account described in § 408(q) is exempt from taxation under § 408(e).

Rev. Rul. 81–100 holds that if certain requirements are satisfied, a group trust is exempt from taxation under § 501(a) with respect to its funds that equitably belong to participating trusts described in § 401(a) and also is exempt from taxation under § 408(e) with respect to its funds that equitably belong to individual retirement accounts that satisfy the requirements of § 408. Also, the status of individual trusts as qualified under § 401(a), or as meeting the requirements of § 408 and as being exempt from tax under § 501(a) or § 408(e), are not affected by the pooling of their funds in a group trust.

Section 457 provides that compensation deferred under an eligible deferred compensation plan of an eligible employer that is a State or political subdivision, agency, or instrumentality thereof (an eligible governmental plan) and any income attributable to the amounts deferred, is includible in gross income only in the taxable year in which it is paid to the plan participant or beneficiary. Section 457(g)(1) requires an eligible governmental plan under § 457(b) to hold all assets and income of the plan in a trust for the exclusive benefit of participants and their beneficiaries. Section 457(g)(2) provides, in part, that a trust described in § 457(g)(1) is treated as an organization exempt from federal income tax under § 501(a). Section 457(g)(3) provides that custodial account and contracts described in § 401(f) are treated as trusts under rules similar to the rules under § 401(f).

This revenue ruling extends the holding of Rev. Rul. 81–100 to eligible governmental plans described in § 457(b). Therefore, if the requirements below are satisfied, the funds from qualified plan trusts, individual retirement accounts (including a Roth individual retirement account described in § 408A and a deemed individual retirement account described in § 408(q)) that are tax-exempt under § 408(e), and eligible governmental plan trusts described in § 457(b) and § 457(g) may be pooled without adversely affecting the tax status of the group trust or the tax status of the separate trusts.

HOLDING

The assets of eligible governmental plan trusts described in § 457(b) may be pooled with the assets of a group trust described in Rev. Rul. 81–100 without affecting the tax status of the eligible governmental plan trust or the group trust (including its current participants).

Accordingly, under Rev. Rul. 81–100 and this revenue ruling, if the five criteria below are satisfied, a trust that is part of a qualified retirement plan, an individual retirement account (including a Roth individual retirement account described in § 408A and a deemed individual retirement account described in § 408(q)) that is exempt from taxation under § 408(e), or an eligible governmental plan under § 457(b) may pool its assets in a group trust without adversely affecting the tax status of any of the separate trusts or the group trust. For this purpose, a trust includes a custodial account that is treated as a trust under § 401(f), under § 408(h), or under § 457(g)(3).

1. The group trust is adopted as a part of each adopting employer's plan or each adopting individual retirement account.

2. The group trust instrument expressly limits participation to pension, profit-sharing, and stock bonus trusts or custodial accounts qualifying under § 401(a) that are exempt under § 501(a); individual retirement accounts that are exempt under § 408(e); and eligible governmental plan trusts or custodial accounts under § 457(b) that are exempt under § 457(g) (adopting entities).

3. The group trust instrument prohibits any part of its corpus or income that equitably belongs to any adopting entity from being used for or diverted to any purpose other than for the exclusive benefit of the employees (and the individual for whom an individual retirement account is maintained) and their beneficiaries who are entitled to benefits under such adopting entity.

4. The group trust instrument prohibits assignment by an adopting entity of any part of its equity or interest in the group trust.

5. The group trust is created or organized in the United States and is maintained at all times as a domestic trust in the United States.

MODEL AMENDMENTS

There are two model amendments set forth below. One is for those group trusts that have received favorable determination letters from the Service that the group trust satisfies Rev. Rul. 81–100. The other is for those trusts of eligible governmental plans under § 457(b) that have received a letter ruling from the Service (in each instance issued prior to July 12, 2004).

AMENDMENT 1—FOR GROUP TRUST

A sponsor of a group trust that satisfies Rev. Rul. 81–100 may amend its group trust to include the model language below to reflect this revenue ruling:

> "This group trust is operated or maintained exclusively for the commingling and collective investment of funds from other trusts that it holds. Notwithstanding any contrary provision in this group trust, the trustee of this group trust is permitted, unless restricted in writing by the named fiduciary, to hold in this group trust funds that consist exclusively of trust assets held under plans qualified under Code section 401(a), individual retirement accounts that are exempt under Code section 408(e), and eligible governmental plans that meet the requirements of Code section 457(b). For this purpose, a trust includes a custodial account that is treated as a trust under Code section 401(f) or under Code section 457(g)(3)."
>
> "For purposes of valuation, the value of the interest maintained by the fund with respect to any plan or account in such group trust shall be the fair market value of the portion of the fund held for that plan or account, determined in accordance with generally recognized valuation procedures."

RELIANCE BY TRUSTEES WITH PRIOR DETERMINATION LETTER

A trustee entitled to rely on a favorable determination letter issued to it prior to July 12, 2004, regarding eligibility of its group trust under Rev. Rul. 81–100 will not lose its right to rely on its determination letter merely because it adopts Model Amendment 1 set forth above in this revenue ruling on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects). The group trust sponsor may adopt Model Amendment 1 on a word-for-word basis (or adopt an amendment that is substantially similar in all material respects) and continue to rely on the previously issued determination letter regarding its group trust without filing another request with the Service for a new determination letter.

A sponsor that satisfies the above requirements and amends its group trust to include Model Amendment 1 on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects) will also not lose its right to rely on its prior determination letter merely because it becomes necessary, as a result of the adoption of such model amendment (or an amendment that is substantially similar in all material respects), to delete a prior provision that is inconsistent with the model amendment so adopted (or an amendment that is substantially similar in all material respects that is so adopted).

Generally, the group trust instrument will provide that amendments to the group trust will automatically pass through to the trusts of qualified plans under § 401(a); individual retirement accounts that are exempt under § 408(e); and trusts of eligible governmental plans under § 457(b). However, a group trust that has received a favorable determination letter under Rev. Proc. 2004–6, 2004–1 I.R.B. 204, (or its predecessors) that does not contain such a pass-through provision may not adopt Model Amendment 1 and automatically continue to rely on its determination letter. In addition, further guidance will be issued to address the transition necessary to bring into compliance a group trust that has received a favorable determination letter under Rev. Proc. 2004–6, 2004–1 I.R.B. 204, (or its predecessors) that does not comply with this revenue ruling.

AMENDMENT 2 — FOR ELIGIBLE GOVERNMENTAL PLAN UNDER § 457(b)

A plan sponsor of a trust that funds an eligible governmental plan under § 457(b) may amend the trust agreement to include the model language below to reflect this revenue ruling:

> "Notwithstanding any contrary provision in the instrument governing the [NAME OF ELIGIBLE GOVERNMENTAL PLAN UNDER § 457(b)], the plan trustee may, unless restricted in writing by the named fiduciary, transfer assets of the plan to a group trust that is operated or maintained exclusively for the commingling and collective investment of monies provided that the funds in the group trust consist exclusively of trust assets held under plans qualified under Code section 401(a), individual retirement accounts that are exempt under Code section 408(e), and eligible governmental plans that meets the requirements of Code section 457(b). For this purpose, a trust includes a custodial account that is treated as a trust under Code section 401(f) or under Code section 457(g)(3)."
>
> "For purposes of valuation, the value of the interest maintained by the [NAME OF ELIGIBLE GOVERNMENTAL PLAN UNDER §457] in such group trust shall be the fair market value of the portion of the group trust held for the [NAME OF ELIGIBLE GOVERNMENTAL PLAN UNDER § 457(b)], determined in accordance with generally recognized valuation procedures."

RELIANCE BY EMPLOYER ON PRIOR § 457(b) RULING

An employer described in section 457(e)(1)(A) entitled to rely on a favorable private letter ruling issued to it prior to July 12, 2004, regarding the eligibility of its plan under § 457(b) will not lose its right to rely on its letter ruling merely because it adopts Model Amendment 2 set forth above on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects). Such an employer may adopt Model Amendment 2 on a word-for-word basis (or adopt an amendment that is substantially similar in all material respects) and continue to rely on the previously issued letter ruling regarding its § 457(b) plan without filing another request with the Service for a new letter ruling.

An employer described in § 457(e)(1)(A) that satisfies the above requirements and amends the trust of its eligible governmental plan under § 457(b) to include Model Amendment 2 on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects) will not lose its right to rely on its prior letter ruling merely because it becomes necessary as a result of the adoption of such model amendment (or an amendment that is substantially similar in all material respects), to delete a prior provision that is inconsistent with the model amendment so adopted.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 81–100 is clarified and modified.

DRAFTING INFORMATION

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

Part III. Administrative, Procedural, and Miscellaneous

Charitable Contributions and Conservation Easements

Notice 2004–41

The Internal Revenue Service is aware that taxpayers who (1) transfer an easement on real property to a charitable organization, or (2) make payments to a charitable organization in connection with a purchase of real property from the charitable organization, may be improperly claiming charitable contribution deductions under § 170 of the Internal Revenue Code. The purpose of this notice is to advise participants in these transactions that, in appropriate cases, the Service intends to disallow such deductions and may impose penalties and excise taxes. Furthermore, the Service may, in appropriate cases, challenge the tax-exempt status of a charitable organization that participates in these transactions. In addition, this notice advises promoters and appraisers that the Service intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers may be subject to penalties.

Contributions of Conservation Easements

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)) that is made within the taxable year. Generally, to be deductible as a charitable contribution under § 170, a transfer to a charitable organization must be a gift of money or property without receipt or expectation of receipt of adequate consideration, made with charitable intent. *See U.S. v. American Bar Endowment*, 477 U.S. 105, 117–18 (1986); *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989); *see also* § 1.170A–1(h)(1) and (2) of the Income Tax Regulations.

Section 170(f)(3) provides generally that no charitable contribution deduction is allowed for a transfer to a charitable organization of less than the taxpayer's entire interest in property. Section 170(f)(3)(B)(iii) provides an exception to this rule in the case of a qualified conservation contribution.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for certain conservation purposes. Section 170(h)(1), (2), (3), and (4); § 1.170A–14(a). A qualified real property interest includes a restriction (granted in perpetuity) on the use that may be made of the real property. Section 170(h)(2)(C); *see also* § 1.170A–14(b)(2). For purposes of this notice, qualified real property interests described in § 170(h)(2)(C) are referred to as conservation easements.

One of the permitted conservation purposes listed in § 170(h)(4) is the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem. Section 170(h)(4)(A)(ii); *see also* § 1.170A–14(d)(1)(ii) and (3). Another of the permitted conservation purposes is the preservation of open space ("open space easement"), including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy. However, if the public benefit of an open space easement is not significant, the charitable contribution deduction will be disallowed. *See* § 170(h)(4)(A)(iii); *see also* § 1.170A–14(d)(1)(iii) and (4)(iv), (v), and (vi). Section 170(h) and § 1.170A–14 contain many other requirements that must be satisfied for a contribution of a conservation easement to be allowed as a deduction.

A charitable contribution is allowed as a deduction only if substantiated in accordance with regulations prescribed by the Secretary. Section 170(a)(1) and (f)(8). Under § 170(f)(8), a taxpayer must substantiate its contributions of $250 or more by obtaining from the charitable organization a statement that includes (1) a description of any return benefit provided by the charitable organization, and (2) a good faith estimate of the benefit's fair market value. *See* § 1.170A–13 for additional substantiation requirements. In appropriate cases, the Service will disallow deductions for conservation easement transfers if the taxpayer fails to comply with the substantiation requirements. The Service is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements.

If all requirements of § 170 are satisfied and a deduction is allowed, the amount of the deduction may not exceed the fair market value of the contributed property (in this case, the contributed easement) on the date of the contribution (reduced by the fair market value of any consideration received by the taxpayer). *See* § 1.170A–1(c)(1), (h)(1) and (2). Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts. Section 1.170A–1(c)(2). *See* § 1.170A–14(h)(3) and (4) for a discussion of valuation.

If the donor (or a related person) reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of a conservation easement, no deduction is allowable. Section 1.170A–14(h)(3)(i). If the donation of a conservation easement has no material effect on the value of real property, or enhances rather than reduces the value of real property, no deduction is allowable. Section 1.170A–14(h)(3)(ii).

Purchases of Real Property from Charitable Organizations

Some taxpayers are claiming inappropriate charitable contribution deductions under § 170 for cash payments or easement transfers to charitable organizations in connection with the taxpayers' purchases of real property.

In some of these questionable cases, the charitable organization purchases the property and places a conservation easement on the property. Then, the charitable organization sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As part of the sale, the buyer makes a second payment, designated as a "charitable contribution," to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property.

In appropriate cases, the Service will treat these transactions in accordance with their substance, rather than their form. Thus, the Service may treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property.

Penalties, Excise Taxes, and Tax-Exempt Status

Taxpayers are advised that the Service intends to disallow all or part of any improper deductions and may impose penalties under § 6662.

The Service intends to assess excise taxes under § 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction. In appropriate cases, the Service may challenge the tax-exempt status of the organization, based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.

In addition, the Service intends to review promotions of transactions involving improper deductions for conservation easements. Promoters, appraisers, and other persons involved in these transactions may be subject to penalties under §§ 6700, 6701, and 6694.

DRAFTING INFORMATION

The principal author of this notice is Patricia M. Zweibel of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Zweibel at (202) 622–5020 (not a toll-free call).

Request For Comments Regarding Rev. Proc. 81–70, 1981–2 C.B. 729

Notice 2004–44

Section 368(a)(1)(B) of the Internal Revenue Code defines as a reorganization the acquisition by one corporation, in exchange solely for all or part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition) (a B reorganization). Section 362(b) generally provides that the basis of property acquired by a corporation in connection with a reorganization shall be the same as it would be in the hands of the transferor. Therefore, the acquiring corporation's basis in the stock acquired in a B reorganization is determined by reference to the basis of the former shareholders in such stock.

In Rev. Proc. 81–70, 1981–2 C.B. 729, the Internal Revenue Service set forth guidelines for estimating the basis of stock acquired by an acquiring corporation in a B reorganization. That revenue procedure permits the acquiring corporation in a B reorganization to apply certain statistical sampling techniques to determine its basis in the acquired stock. The guidelines reflect the recognition that the information needed by the acquiring corporation to establish the basis of the acquired corporation's stock is in the possession of the former shareholders of the acquired corporation, who may not respond to basis inquiries. They also reflect the recognition that, in certain cases, it may be time consuming, burdensome and costly for the acquiring corporation to contact each former shareholder of the acquired corporation.

The Service is concerned that changes in the marketplace since Rev. Proc. 81–70 was issued may have rendered compliance with its requirements for statistical sampling unduly burdensome or impossible and that, therefore, taxpayers are not complying with those requirements. For example, the Service understands that the way stock is held today may prevent or hinder access to the information necessary to determine the shareholder's basis in such stock.

A number of commentators have suggested that the Service revise Rev. Proc. 81–70. The Service requests comments regarding problems taxpayers are encountering in their effort to comply with the requirements of Rev. Proc. 81–70 and whether it should be modified.

The Service particularly seeks comments from those who perform basis studies that are intended to comply with the requirements of Rev. Proc. 81–70, those engaged in providing services and information to the investment community (including those who maintain custodial information that may be used in such studies, such as broker/dealers, banks, and similar organizations), and other interested parties.

In addition, from those that perform basis studies that are intended to comply with the requirements of Rev. Proc. 81–70, the following information is specifically requested: (i) descriptions of the sources of information, both historic and recent, available for use in performing basis studies; and (ii) descriptions of the methodologies utilized to determine the basis of stock held by persons that do not respond to requests for basis information.

From record keepers, the following information is specifically requested: (i) descriptions of the kinds of information that are maintained that may be used to perform basis studies and of the sources of this information; (ii) statements describing the length of time that this information is generally maintained and available for use; and (iii) descriptions of confidentiality concerns, if any, that may impair or delay a response to a basis inquiry.

Please submit all comments by September 30, 2004. Written comments should be sent to:

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2004–44)
Room 5203
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044

Or hand delivered between the hours of 8 a.m. and 4 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2004–44)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov.* Please include "Notice 2004–44" in the subject line. All comments will be available for public inspection and copying in their entirety.

FOR FURTHER INFORMATION

For information regarding estimates and sampling techniques, please contact Edward Cohen at (212) 719–6693 (not a toll-free call). For further information regarding this notice generally, please contact George Johnson or Reginald Mombrun at (202) 622–7930 (not a toll-free call).

Meritless Filing Position Based on Sections 932(c) and 934(b)

Notice 2004–45

The Internal Revenue Service is aware that certain promoters are advising taxpayers to take highly questionable, and in most cases meritless, positions described below in order to avoid U.S. taxation and claim a tax benefit under the laws of the United States Virgin Islands (USVI). Promoters may also be advising taxpayers to take similar positions with respect to other U.S. possessions. This notice alerts taxpayers that the Service intends to challenge these positions in appropriate cases. The Service may impose civil penalties on taxpayers or persons who participated in the promotion or reporting of these positions. In addition to being subject to other penalties, any person who willfully attempts to evade or defeat tax by means of an arrangement such as the one described in this notice, or who willfully counsels or advises such evasion or defeat, may be guilty of a criminal offense under federal law.

Background

Section 934, which was enacted in 1960, provides that the USVI may reduce its territorial income tax only in certain limited cases. The USVI may not, however, reduce the tax liability of U.S. citizens or residents who are not *bona fide* residents of the USVI. In the case of U.S. citizens or residents who are *bona fide* residents of the USVI, it may reduce their tax liability only with respect to income from sources in the USVI or income effectively connected with the conduct of a trade or business within the USVI.

The legislative history of § 934 indicates that the statute was enacted in part because of concerns that certain local income tax programs, which were intended to provide incentives to corporations and USVI residents that made new investments in the USVI, were having the effect of reducing the tax liability attributable not only to income from sources within the USVI but also to income from sources within the United States. While recognizing the goal of encouraging economic development in the USVI through appropriate income tax reductions, the legislative history to § 934 indicates that

> in no case should this [goal] be attained by granting windfall gains to taxpayers with respect to income derived from investments in corporations in the continental United States, or with respect to income in any other manner derived from sources outside of the Virgin Islands.

S. Rep. No. 1767, 86th Cong., 2nd Sess. 4 (1960).

Typical Promotion

The highly questionable positions described in this notice may be promoted to taxpayers in a variety of forms. The Service is aware, however, that they have frequently been promoted in the following manner:

Promoters typically approach a taxpayer (Taxpayer) living and working in the United States and advise Taxpayer to (i) purport to become a USVI resident by establishing certain contacts with the USVI, (ii) purport to terminate his or her existing employment relationship with his or her employer (Employer) and (iii) purport to become a partner of a Virgin Islands limited liability partnership ("V.I.LLP") that is treated as a partnership for U.S. tax purposes. V.I.LLP then purports to enter into a contract with Employer to provide Employer with substantially the same services that were provided by Taxpayer prior to the creation of this arrangement. Typically, after entering into the arrangement, Taxpayer continues to provide substantially the same services for Employer that he or she provided before entering into the arrangement, but Taxpayer is nominally a partner of V.I.LLP instead of an employee of Employer.

Under this arrangement, Employer makes payments to V.I.LLP for Taxpayer's services and no longer treats the payments as wages paid to Taxpayer subject to the withholding and payment of employment taxes and reporting on Taxpayer's Form W–2. V.I.LLP, in turn, makes payments to Taxpayer for his or her services to Employer. V.I.LLP typically treats these payments for tax accounting purposes either as guaranteed payments for services or as distributions of Taxpayer's allocable share of partnership income. Under this arrangement, the promoter may be a general partner in V.I.LLP and may retain a percentage of the fees received from Employer.

V.I.LLP either has or secures a reduction, up to 90 percent, in USVI income tax liability under the Economic Development Program (EDP) of the USVI. Taxpayer takes the position that the EDP benefits granted to V.I.LLP provide a corresponding reduction in the income tax liability that Taxpayer reports on his or her USVI income tax return with respect to guaranteed payments from the partnership or distributive shares of the partnership's net income, or both. Taxpayer pays tax to the USVI in an amount approximately equal to 10% of the U.S. income tax liability that otherwise would be imposed on Taxpayer's income from performing the services. Taxpayer claims that, for purposes of computing his or her U.S. income tax liability, gross income does not include guaranteed payments received from V.I.LLP or Taxpayer's distributive share, if any, of the partnership's net income, or both.

Positions Promoted

In situations such as those described above, as well as in other situations, the following highly questionable positions are being promoted:

> **—"You can continue to live and work in the United States and, nevertheless, be a *bona fide* resident of the USVI."** The concept of a "*bona fide* resident of the Virgin Islands" was an integral part of the predecessor to § 934(b), and as such, its meaning has been well established. *See* § 934(c) as enacted by P.L. 86–779, §4(a) (1960). When Congress enacted the current versions of §§ 932 and 934(b), it retained this concept, but noted that Treasury has the authority to modify its meaning when necessary to prevent abuse. *See* H.R. Rep. No. 99–426 (1985) and General Explanation of the Tax Reform Act of 1986, JCS–10–87 (1987) ("Similarly, where appropriate, the Secretary may treat an individual as not

a *bona fide* resident of the Virgin Islands.") The determination of whether an individual is a *bona fide* resident of the USVI turns on the facts and circumstances and, specifically, on an individual's intentions with respect to the length and nature of his or her stay in the USVI. *See* § 1.934–1(c)(2) (generally applying the principles of §§ 1.871–2 through –5). Promoters typically represent that a taxpayer need not make major lifestyle changes in order to become a *bona fide* resident of the USVI, and may represent that the taxpayer need only spend a few weeks or less out of the year in the USVI to become a resident for income tax purposes. These representations, however, have no basis in the well-established meaning of the term "*bona fide* resident of the Virgin Islands." Accordingly, a claim of USVI residency for income tax purposes may be considered without merit or fraudulent when the taxpayer continues to live and work in the United States.

—"USVI source income includes income from services performed in the United States." The principles that generally apply for determining gross and taxable income from sources within and without the United States (in particular, the rules of §§ 1.861–1 through 1.863–5) also generally apply in determining gross and taxable income from sources within and without a possession of the United States. *See* § 1.863–6 and *Francisco v. Commissioner*, 119 T.C. 317 (2002) *aff'd*, No. 03–1210 (D.C. Cir. June 18, 2004). With certain limited exceptions, compensation for labor or personal services performed in the United States is gross income from sources within the United States. *See* § 861(a)(3) and § 1.861–4(a)(1). The result does not change if the compensation is received in the form of a guaranteed payment from a partnership rather than in the form of a fee for services under an employment contract. *See Miller v. Commissioner*, 52 T.C. 752 (1969), *acq.* 1972–2 C.B. 2. Promoters typically claim that taxpayers are free to argue, under a variety of theories, that income from services performed in the United States constitutes income from USVI sources because "no rules exist under section 934" for determining whether income is from USVI sources. Based on the foregoing discussion, however, such arguments are without merit.

—"For purposes of determining the source of income, USVI includes the United States." Section 932 provides coordination rules for filing of returns for U.S. and USVI income taxes by *bona fide* residents of the USVI and U.S. citizens and residents who have income derived from sources within the USVI or income effectively connected with the conduct of a trade or business within the USVI. To facilitate this coordination, § 932(c)(3) states that the USVI includes the United States for certain tax purposes. Section 932(c)(3) was modeled after § 935(c), which was enacted fourteen years earlier and which provides an equivalent rule with respect to Guam. For an illustration of the types of purposes for which these provisions apply, *see* § 1.935–1(c)(1)(ii). Notably, these provisions do not apply for purposes of determining the source of income. *See* H.R. Rep. No. 92–1479, 92d Cong., 2d Sess. 5 (Oct. 2, 1972) ("In determining the source of income for purposes of the special tax system provided in the bill (new code sec. 935), the principles contained in secs. 861–863 are to be applied without reference to sec. 935(c).") Based on an incorrect reading of § 932(c)(3), promoters may claim that compensation for services performed in the United States is considered for tax purposes to be compensation for services performed in the USVI. This claim is without merit. Section 932 does not apply to determine the source of income on which the USVI tax liability of *bona fide* residents may be reduced under § 934(b)(1). Thus, § 932(c)(3) does not operate to transform compensation from the performance of personal services in the United States into income from sources in the USVI.

—"Non-USVI source income can be treated as effectively connected with the conduct of a trade or business within the USVI even if, under equivalent circumstances, such income would not be considered effectively connected with the conduct of a trade or business within the United States." As noted above, § 934(b)(1) grants limited authority to the USVI to reduce the USVI tax liability with respect to income from USVI sources or income effectively connected with a trade or business within the USVI. The use of the term "effectively connected with the conduct of a trade or business" in § 934 indicates that Congress generally intended for the rules under § 934 to follow the well-established rules that apply for purposes of determining the taxation of nonresidents, such as the definition of effectively connected income under § 864(c). Section 934(b)(4), however, provides Treasury with the authority to issue regulations providing an alternative definition of the term. The legislative history of § 934 makes clear that this grant of regulatory authority was for the purpose of preventing abuse, and that Congress anticipated that it would be used to provide further limitations on the type of income that would be treated as from USVI sources or as effectively connected with the conduct of a trade or business within the USVI. S. Rep. No. 99–313, at 484, 1986–3 C.B. (vol. 3) 484. Taxpayers have no legal basis for claiming that the scope of the term "income effectively connected with the conduct of a trade or business" is broader under § 934 than it is under § 864. In particular, taxpayers have no legal basis for disregarding the rules of § 864(c)(4), which generally limit the amount of foreign source income that is treated as effectively connected with a U.S. trade or business to certain, very narrow categories of income. Accordingly, with the exception of those narrow categories, and in the absence of regulations to the contrary, income, gain, or loss from sources without the USVI cannot be treated as effectively connected with the conduct of a trade or business within the USVI for purposes of § 934. For example, income from the performance of personal services without the USVI cannot under any circumstances be treated as effectively connected with the conduct of a trade or business within the USVI. Promoters typically interpret the phrase "effectively connected to the conduct of a trade or business within the USVI" broadly, and inconsistently with § 864(c)(4), in order to claim a tax reduction with respect to income from non-USVI sources. As indicated above, however, these interpretations have no merit.

The IRS intends to challenge these positions and other similar claims that disregard the statutory and regulatory provisions concerning the limitations on the reduction of USVI income tax. Where taxpayers in order to make these claims enter into arrangements such as the one described in this notice, the Internal Revenue Service may disregard such arrangements on the grounds that they lack economic substance or that they have no purpose other than tax avoidance or evasion. The Service also may assert that the arrangement does not serve to terminate the employment relationship between a taxpayer and Employer for federal employment tax purposes, with the result that Employer remains liable for employment taxes and applicable penalties and interest.

In addition to liability for tax due plus statutory interest, taxpayers that claim to have no requirement to file a federal income tax return or pay federal income tax liability based on the positions described herein may be subject to penalties including, but not limited to, the accuracy-related penalty under § 6662, failure to file or pay penalties under § 6651 and civil fraud penalties under § 6663. Further, persons who participate in the promoting or reporting of these positions may be subject to aiding and abetting penalties under § 6701. In addition to other penalties, any person who willfully attempts to evade or defeat tax by taking the positions described in this notice, or who willfully counsels or advises such evasion or defeat, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law. Promoters and others who assist taxpayers in taking these positions also may be enjoined from doing so under § 7408.

The principal author of this notice is W. Edward Williams of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact W. Edward Williams at (202) 622–3295 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Adjustment to Net Unrealized Built-in Gain

REG–131486–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1374 that provide for an adjustment to the amount that may be subject to tax under section 1374 in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which section 1374(d)(8) applies. These proposed regulations provide guidance to certain S corporations that acquire assets from a C corporation in a carryover basis transaction.

DATES: Written or electronic comments must be received by September 23, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–131486–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–131486–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS — REG–131486–03). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jennifer Sledge, (202) 622–7750; concerning submissions of comments, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Section 1374 of the Internal Revenue Code of 1986 (Code) generally imposes a corporate level tax on the income or gain of an S corporation that formerly was a C corporation to the extent the income or gain is attributable to the period during which the corporation was a C corporation. Congress amended section 1374 to provide this rule as part of the Tax Reform Act of 1986, which repealed the *General Utilities* doctrine. Under the *General Utilities* doctrine, a C corporation, in certain cases, could distribute appreciated assets to its shareholders, or sell appreciated assets and distribute the sale proceeds in connection with a complete liquidation to its shareholders, without recognizing gain. Section 1374 prevents a corporation from circumventing *General Utilities* repeal by converting to S corporation status before distributing its appreciated assets to its shareholders, or selling its appreciated assets and distributing the sale proceeds in connection with a complete liquidation to its shareholders.

Specifically, section 1374 imposes a tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation for the 10-year recognition period beginning on the first day the corporation is an S corporation. Under section 1374, the total amount subject to tax is limited to the S corporation's net unrealized built-in gain (NUBIG), which is the "aggregate net built-in gain of the corporation at the time of conversion to S corporation status." See H.R. Conf. Rep. No. 99–841, at II–203 (1986). Section 1374 also imposes a tax on an S corporation's net recognized built-in gain attributable to assets that it acquired in a carryover basis transaction from a C corporation for the 10-year recognition period beginning on the day of the carryover basis transaction. The legislative history of section 1374 provides that each acquisition of assets from a C corporation is subject to a separate determination of the amount of net unrealized built-in gain and is subject to a separate 10-year recognition period. See H.R. Rep. No. 100–795, at 63 (1988).

Sections 337(d) and 1374(e) authorize the Secretary of the Treasury to prescribe regulations as necessary to carry out the purposes of *General Utilities* repeal generally and section 1374 specifically. The Treasury Department and the IRS have promulgated regulations consistent with these provisions. See, *e.g.*, §§1.337(d)–4 through 1.337(d)–7, 1.1374–1 through 1.1374–10.

Under §1.1374–3, an S corporation's NUBIG generally is the amount of gain the S corporation would recognize on the conversion date if it sold all of its assets at fair market value to an unrelated party that assumed all of its liabilities on that date. Consistent with the legislative history of section 1374, section 1374(d)(8) and §1.1374–8 require a separate determination of the amount subject to tax under section 1374 for the pool of assets the S corporation held on the date it converted to C status and each pool of assets acquired in a carryover basis transaction from a C corporation.

Under the current rules, therefore, if X, a C corporation, elects to be an S corporation when it owns all of the stock of Y, a C corporation, X's NUBIG will reflect the built-in gain or built-in loss in the Y stock. That built-in gain or built-in loss may be duplicative of the built-in gain or built-in loss in Y's assets. If Y later transfers its assets to X in a liquidation to which sections 332 and 337(a) apply, the built-in gain and built-in loss in Y's assets may be reflected twice: once in the NUBIG attributable to the assets X owned on the date of its conversion (including the stock of Y) and a second time in the NUBIG attributable to Y's former assets acquired by X in the liquidation of Y. A similar result would obtain if, on the date of its conversion to an S corporation, X owned less than 80 percent of the stock of Y and later acquired the assets of Y in a reorganization to which section 368(a) applies. These results are inconsistent with the fact that a liquidation to which sections 332 and 337(a) apply, and the acquisition of the assets of a corporation some or all of the stock of which is owned by the acquiring corporation in a reorganization under section 368(a), generally have the effect of eliminating the built-in gain or built-in loss in the redeemed or canceled stock of the liquidated or target corporation.

In the course of developing these proposed regulations, the Treasury Department and the IRS considered a number of approaches to address the issue raised by the situations described above. In particular, the Treasury Department and the IRS considered adopting an approach that would provide for a single determination of NUBIG for all of the assets of an S corporation and, thus, a single determination of the amount subject to tax under section 1374. While this approach may have produced results similar to those that would have been produced had the S corporation remained a C corporation and acquired the assets of another C corporation, it was rejected because such an approach appears to be inconsistent with the legislative history of section 1374, which seems to mandate a separate determination of tax for each pool of assets. See H.R. Rep. No. 100–795, at 63.

Instead, these regulations adopt an approach that adjusts (increases or decreases) the NUBIG of the pool of assets that included the stock of the liquidated or acquired C corporation to reflect the extent to which the built-in gain or built-in loss inherent in the redeemed or canceled C corporation stock at the time the pool of assets became subject to the tax under section 1374 has been eliminated from the corporate tax system in the liquidation or reorganization. These proposed regulations provide that, if section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the C corporation from which such assets were acquired was taken into account in the computation of NUBIG for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, subject to certain limitations, the NUBIG of the pool of assets that included the C corporation stock redeemed or canceled in the transaction (other than stock with respect to which a loss under section 165 is claimed) is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled C corporation stock had on the initial computation of NUBIG for that pool of assets. For this purpose, stock that has an adjusted basis that is determined (in whole or in part) by reference to the adjusted basis of any other asset held by the S corporation as of the first day of the recognition period (*i.e.*, stock described in section 1374(d)(6)) is treated as taken into account in the computation of the NUBIG for the pool of assets of the S corporation.

Adjustments to NUBIG under these proposed regulations, however, are subject to two limitations. First, the NUBIG is only adjusted to reflect the amount of the built-in gain or built-in loss that was inherent in the redeemed or canceled stock at the time the pool of assets became subject to tax under section 1374 that has not resulted in recognized built-in gain or recognized built-in loss at any time during the recognition period, including on the date of the acquisition to which section 1374(d)(8) applies. For example, suppose that on the date X, a C corporation, converts to S corporation status, it owns the stock of Y, which has a basis of $0 and a value of $100. The gain inherent in the Y stock contributes $100 to X's NUBIG. During the recognition period and prior to the liquidation of Y, Y distributes $20 to X in a distribution to which section 301(c)(3) applies. That amount is recognized built-in gain under section 1374(d)(3). If Y later distributes its assets to X in a distribution to which sections 332 and 337(a) apply, pursuant to these regulations, X must adjust its original NUBIG to reflect the elimination of the Y stock. X will reduce that NUBIG by $80, the original built-in gain in such stock ($100) minus the recognized built-in gain with respect to such stock during the recognition period ($20).

Second, an adjustment cannot be made if it is duplicative of another adjustment to the NUBIG for a pool of assets. This rule is intended to prevent more than one adjustment to the NUBIG of a pool of assets for the same built-in gain or built-in loss stock.

Any adjustment to NUBIG under these proposed rules will only affect computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the liquidation or reorganization. It will not affect computations of the amount subject to tax under section 1374 for taxable years that end before the date of the liquidation or reorganization.

The Treasury Department and IRS request comments regarding whether the rule proposed in these regulations should be expanded to apply in other cases in which the stock basis that was taken into account in the computation of NUBIG is eliminated. This may occur, for example, where an S corporation owns stock of a C corporation on the date of its conversion to an S corporation and later distributes the stock of the C corporation in a distribution to which section 355 applies. In addition, the Treasury Department and IRS request comments concerning whether there are any situations other than those identified in these proposed regulations in which adjustments to NUBIG should be less than the built-in gain or the built-in loss in the redeemed or canceled stock as of the beginning of the recognition period.

Special Analyses

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

Public Comment

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be made available for public inspection and copying. A public hearing may be scheduled. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Marie Byrne of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1 — INCOME TAXES

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

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

Par. 2. Section 1.1374–3 is amended by:

1. Revising paragraph (b).
2. Adding paragraph (c).

The revision and addition read as follows:

§1.1374–3 Net unrealized built-in gain.

* * * * *

(b) *Adjustment to net unrealized built-in gain* — (1) *In general*. If section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (b)(2) of this section, such net unrealized built-gain is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

(2) *Limitations on adjustment* — (i) *Recognized built-in gain or loss*. Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

(ii) *Anti-duplication rule*. Paragraph (b)(1) of this section shall not be applied to duplicate an adjustment to the net unrealized built-in gain for a pool of assets made pursuant to paragraph (b)(1) of this section.

(3) *Effect of adjustment*. Any adjustment to the net unrealized built-in gain made pursuant to this paragraph (b) only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the acquisition to which section 1374(d)(8) applies.

(4) *Pool of assets*. For purposes of this section, a pool of assets means —

(i) The assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or

(ii) The assets the S corporation acquired from a C corporation in a section 1374(d)(8) transaction.

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

Example 1. Computation of net unrealized built-in gain. (i)(A) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000

Liabilities	Amount
Mortgage	$200,000
Accounts Payable	100,000
Total	300,000

(B) Further, X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be $1,050,000 ($750,000 cash received + $300,000 liabilities assumed = $1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized	$1,050,000
Deduction allowed	(100,000)
Basis of X's assets	(900,000)
Section 481 adjustments	60,000
Net unrealized built-in gain	110,000

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $15,000. Among the

assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $33,000 and an adjusted basis of $18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has $10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is $50,000. Effective June 1, 2009, X elects under section 1362 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by $15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $0.

(iii) Under §1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $10,000, X's taxable income limitation is $50,000, and X's net unrealized built-in gain limitation is $0. Because the net unrealized built-in gain of the first pool of assets has been adjusted to $0, despite the $10,000 of recognized built-in gain in 2009, X has $0 net recognized built-in gain for the taxable year ending on December 31, 2009.

Example 3. Adjustment to net unrealized built-in gain for built-in loss in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of negative $5,000. Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of $18,000 and an adjusted basis of $33,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, resulting in $8,000 of recognized built-in gain. X has had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is $50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the reorganization. The net unrealized built-in gain of the first pool of assets, therefore, is increased by $15,000, the amount by which the adjusted basis of the Y stock exceeded its fair market value as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $10,000.

(iii) Under §1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $8,000 and X's taxable income limitation is $50,000. The net unrealized built-in gain of the first pool of assets has been adjusted to $10,000, so X's net unrealized built-in gain limitation is $10,000. X, therefore, has $8,000 net recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is $2,000.

Example 4. Adjustment to net unrealized built-in gain in case of prior gain recognition. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $30,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $45,000 and an adjusted basis of $10,000. Y has no current or accumulated earnings and profits. On April 1, 2007, Y distributes $18,000 to X, $8,000 of which is treated as gain to X from the sale or exchange of property under section 301(c)(3). That $8,000 is recognized built-in gain to X under section 1374(d)(3), and results in $8,000 of net recognized built-in gain to X for 2007. X's net unrealized built-in gain limitation for 2008 is $22,000. On June 1, 2009, Y transfers its assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of that pool of assets, however, can only be adjusted to reflect the amount of built-in gain that was inherent in the Y stock on January 1, 2005, that has not resulted in recognized built-in gain during the recognition period. In this case, therefore, the net unrealized built-in gain of the first pool of assets cannot be reduced by more than $27,000 ($35,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005, minus $8,000, the recognized built-in gain with respect to the stock during the recognition period). Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $3,000. The net unrealized built-in gain limitation for 2009 is $0.

Par. 3. Paragraph (a) of §1.1374–10 is revised to read as follows:

§1.1374–10 Effective date and additional rules.

(a) *In general*. Sections 1.1374–1 through 1.1374–9, other than §1.1374–3(b) and (c) *Examples 2* through *4*, apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. Section 1.1374–3(b) and (c) *Examples 2* through *4* apply for taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

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Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 24, 2004, 8:45 a.m., and published in the issue of the Federal Register for June 25, 2004, 69 F.R. 35544)

Notice of Proposed Rulemaking

Stock Held by Foreign Insurance Companies

REG–117307–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains a proposed regulation relating to the determination of income of foreign insurance companies that is effectively connected with the conduct of a trade or business within the United States. The regulation provides that the exception to the asset-use test for stock shall not apply in determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes effectively connected income.

DATES: Written or electronic comments and requests for a public hearing must be received by September 23, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–117307–04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–117307–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–117307–04).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Sheila Ramaswamy, at (202) 622–3870; concerning submissions and delivery of comments, Robin Jones, 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In 1992, the Treasury Department and the IRS published proposed regulations under section 864 providing that stock is not treated as an asset used in, or held for use in, the conduct of a trade or business in the United States. Proposed §1.864–4(c)(2)(ii)(C). The notice of proposed rulemaking solicited comments regarding the appropriate treatment of income from portfolio stock investments of insurance companies. The Treasury Department and the IRS published final regulations in 1996 which adopted the general rule in the proposed regulations that stock is not treated as an asset used in, or held for use in, the conduct of a U.S. trade or business. T.D. 8657, 1996–1 C.B. 153. The final regulations reserved on the treatment of stock held by a foreign insurance company. §1.864–4(c)(2)(iii)(b). This proposed regulation sets forth circumstances in which stock held by a foreign insurance company is not subject to the general rule in §1.864–4(c)(2)(iii)(a), which provides that stock is not an asset used in a U.S. trade or business.

Explanation of Provisions

In the case of a foreign corporation engaged in a trade or business within the United States during the taxable year, section 864(c)(2) generally provides rules for determining whether certain fixed or determinable, annual or periodical income from sources within the United States or gain or loss from sources within the United States from sale or exchange of capital assets is income effectively connected with the conduct of a trade or business in the United States. Section 864(c)(2). In making this determination, the factors taken into account include whether (a) the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business (the asset-use test), or (b) the activities of such trade or business were a material factor in the realization of such income, gain or loss. Section 864(c)(2). Section 1.864–4(c)(2)(iii)(a) generally provides that stock of a corporation (whether domestic or foreign) is not an asset used in or held for use in the conduct of a trade or business in the United States except as provided in (c)(2)(iii)(b). Section 1.864–4(c)(2)(iii)(b) entitled "Stock Held by Foreign Insurance Companies" is reserved.

Insurance companies hold investment assets, such as stocks and bonds, to fund their obligations to policyholders and to meet their surplus (capital) requirements. Thus, stock held in an investment portfolio may be an asset held for use in the trade or business of a foreign insurance company. By contrast, stock of a subsidiary generally is not held for the purpose of meeting an insurance company's business needs.

This proposed regulation provides that the general rule excluding stock from the asset-use test does not apply to stock held by a foreign insurance company unless such company owns directly, indirectly, or constructively 10 percent or more of the vote or value of the company's stock. The 10-percent threshold is intended to distinguish portfolio stock held to fund policyholder obligations and surplus requirements from investments in a subsidiary. Comments are requested as to whether this 10-percent threshold provides an appropriate standard for determining whether stock is a portfolio investment for these purposes.

Proposed Effective Date

This regulation is proposed to apply to taxable periods beginning on or after the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

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

Drafting Information

The principal author of these proposed regulations is Sheila Ramaswamy, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendment to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In §1.864–4, paragraph (c)(2)(iii)(b) is revised to read as follows:

§1.864–4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(iii) * * *

(b) Paragraph (c)(2)(iii) of this section shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation. For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 24, 2004, 8:45 a.m., and published in the issue of the Federal Register for June 25, 2004, 69 F.R. 35543)

Suspension of Tax-Exempt Status of an Organization Identified With Terrorism

Announcement 2004–56

I. Purpose

This announcement is a public notice of the suspension under section 501(p) of the Internal Revenue Code of the federal tax exemption of a certain organization that has been designated as supporting or engaging in terrorist activity or supporting terrorism. Contributions made to an organization during the period that the organization's tax-exempt status is suspended are not deductible for federal tax purposes.

II. Background

The federal government has designated a number of organizations as supporting or engaging in terrorist activity or supporting terrorism under the Immigration and Nationality Act, the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945. Federal law prohibits most contributions to organizations that have been so designated.

Section 501(p) of the Code was enacted as part of the Military Family Tax Relief Act of 2003 (P.L. 108–121), effective November 11, 2003. Section 501(p)(1) suspends the exemption from tax under section 501(a) of any organization described in section 501(p)(2). An organization is described in section 501(p)(2) if the organization is designated or otherwise individually identified (1) under certain provisions of the Immigration and Nationality Act as a terrorist organization or foreign terrorist organization; (2) in or pursuant to an Executive Order which is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or section 5 of the United Nations Participation Act of 1945 for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive Order issued under the authority of any federal law, if the organization is designated or otherwise individually identified in or pursuant to the Executive Order as supporting or engaging in terrorist activity (as defined in the Immigration and Nationality Act) or supporting terrorism (as defined in the Foreign Relations Authorization Act) and the Executive Order refers to section 501(p)(2).

Under section 501(p)(3) of the Code, suspension of an organization's tax exemption begins on the date of the first publication of a designation or identification with respect to the organization, as described above, or the date on which section 501(p) was enacted, whichever is later. This suspension continues until all designations and identifications of the organization are rescinded under the law or Executive Order under which such designation or identification was made.

Under section 501(p)(4) of the Code, no deduction is allowed under any provision of the Internal Revenue Code for any contribution to an organization during any period in which the organization's tax exemption is suspended under section 501(p). Thus, for example, no charitable contribution deduction is allowed under section 170 (relating to the income tax), section 545(b)(2) (relating to undistributed personal holding company income), section 556(b)(2) (relating to undistributed foreign personal holding company income), section 642(c) (relating to charitable set asides), section 2055 (relating to the estate tax), section 2106(a)(2) (relating to the estate tax for nonresident aliens) and section 2522 (relating to the gift tax) for contributions made to the organization during the suspension period.

Prior to the effective date of suspension of exemption under section 501(p), the organization listed below was designated under Executive Order 13224, entitled "Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten To Commit, or Support Terrorism." Contributions made to this organization in violation of the Executive Order prior to this suspension are not tax deductible under the Internal Revenue Code.

III. Notice of Suspension and Nondeductibility of Contributions

The organization whose tax exemption has been suspended under section 501(p) and the effective date of such suspension is listed below. Contributions made to this organization during the period of suspension are not deductible for federal tax purposes.

Rabbi Meir Kahana Memorial Fund
Cedarhurst, New York
Effective Date: November 11, 2003

IV. Federal Tax Filings

An organization whose exempt status has been suspended under section 501(p) does not file Form 990 and is required to file the appropriate Federal income tax returns for the taxable periods beginning on the date of the suspension. The organization must continue to file all other appropriate federal tax returns, including employment tax returns, and may also have to file federal unemployment tax returns.

V. Contact Information

For additional information regarding the designation or identification of an organization described in section 501(p)(2), contact the Compliance Division at the Office of Foreign Assets Control of the U.S. Treasury Department at 202–622–2490. Additional information is also available for download from the Office's Internet Home Page at *www.treas.gov/offices/eotffc/ofac/index.html*

For additional information regarding the suspension of the federal tax exemption of an organization under section 501(p), contact Ward L. Thomas at (202) 283–8913 at the Internal Revenue Service.

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

Bulletins 2004–27 through 2004–28

Announcements:

2004-55, 2004-27 I.R.B. *15*
2004-56, 2004-28 I.R.B. *41*
2004-57, 2004-27 I.R.B. *15*

Notices:

2004-41, 2004-28 I.R.B. *31*
2004-43, 2004-27 I.R.B. *10*
2004-44, 2004-28 I.R.B. *32*
2004-45, 2004-28 I.R.B. *33*

Proposed Regulations:

REG-131486-03, 2004-28 I.R.B. *36*
REG-117307-04, 2004-28 I.R.B. *39*

Revenue Procedures:

2004-38, 2004-27 I.R.B. *10*

Revenue Rulings:

2004-63, 2004-27 I.R.B. *6*
2004-64, 2004-27 I.R.B. *7*
2004-65, 2004-27 I.R.B. *1*
2004-66, 2004-27 I.R.B. *4*
2004-67, 2004-28 I.R.B. *28*

Treasury Decisions:

9131, 2004-27 I.R.B. *2*
9132, 2004-28 I.R.B. *16*
9133, 2004-28 I.R.B. *25*

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.

Findings List of Current Actions on Previously Published Items[1]

Bulletins 2004–27 through 2004–28

Revenue Procedures:

94-64
Superseded by
Rev. Proc. 2004-38, 2004-27 I.R.B. *10*

Revenue Rulings:

81-100
Clarified and modified by
Rev. Rul. 2004-67, 2004-28 I.R.B. *28*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.

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