Internal Revenue
bulletin

Bulletin No. 2004-40
October 4, 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. 9154, page 560.
REG–135898–04, page 568.

Temporary and proposed regulations under section 1502 of the Code extend the time for consolidated groups to make elections, and permit them to amend or revoke prior elections, concerning methods for determining allowable loss on a disposition of subsidiary stock.

T.D. 9155, page 562.
REG–129274–04, page 567.

Temporary and proposed regulations under section 1502 of the Code provide that the application of the deemed waiver rule of regulations section 1.1502–32T(b)(4)(v), which denied the use of excess losses in cases in which such denial was not intended, is elective.

T.D. 9157, page 545.

Final regulations under section 988 of the Code provide for the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's functional currency. This regulation generally provides that taxpayers should apply the existing rules under section 1275 to nonfunctional currency contingent payment debt instruments in the currency in which the debt instrument is denominated, and should then translate those amounts into the taxpayer's functional currency using the rules provided. In addition, a rule is provided to determine the currency in which the calculations should be made, in the case of a multi-currency debt instrument. Announcement 99–76 obsolete.

Announcement 2004–75, page 580.

This document describes rules that the IRS and Treasury may include in proposed regulations (REG–106679–04) regarding the proper timing of income or deduction attributable to an interest-only regular interest in a Real Estate Mortgage Investment Conduit (REMIC). This document also invites comments from the public.

EMPLOYEE PLANS

Notice 2004–60, page 564.

Weighted average interest rate update; corporate bond indices; 30-year Treasury securities. The weighted average interest rate for September 2004 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

Notice 2004–62, page 565.

Minimum funding standards; disaster relief. The Service, the Employee Benefits Security Administration (EBSA) of the Department of Labor, and the Pension Benefit Guaranty Corporation (PBGC) are providing relief in connection with certain employee benefit plans because of damage in Florida caused by Tropical Storm Bonnie, Hurricane Charley, and Hurricane Frances (Florida Storms). The relief provided by this notice is in addition to the relief already provided by the Service to victims of the Florida Storms.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Announcement 2004–71, page 569.

Qualification; determination letters; staggered remedial amendment periods. This announcement includes a draft revenue procedure that contains the Service's procedures for issuing letters pursuant to section 401(a) of the Code with respect to a staggered remedial amendment period system for plans that have not been pre-approved as well as for pre-approved plans. This document also invites comments from the public.

EXEMPT ORGANIZATIONS

Announcement 2004–74, page 579.

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.

Announcement 2004–76, page 588.

A list is provided of organizations now classified as private foundations.

Announcement 2004–78, page 592.

Independent Insurance Agents Association of Queens and Kings Counties, Inc., of Long Island City, NY, no longer qualifies as an organization to which contributions are deductible under section 170 of the Code.

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.

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

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

Section 988.—Treatment of Certain Foreign Currency Transactions

26 CFR 1.988–2: Recognition and computation of exchange gain or loss.

T.D. 9157

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Guidance Regarding the Treatment of Certain Contingent Payment Debt Instruments With One or More Payments That Are Denominated in, or Determined by Reference to, a Nonfunctional Currency

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations regarding the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's functional currency. These regulations are necessary because current regulations do not provide guidance concerning the tax treatment of such instruments. The regulations affect issuers and holders of such instruments.

DATES: *Effective Date:* These regulations are effective August 30, 2004.

Applicability Date: These regulations apply to debt instruments issued on or after October 29, 2004.

FOR FURTHER INFORMATION CONTACT: Milton Cahn, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1831. Responses to these collections of information are mandatory.

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

The estimated annual burden per [respondent/recordkeeper] varies from 48 minutes to 1 hour 12 minutes, depending on individual circumstances, with an estimated average of 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

This document contains amendments to 26 CFR part 1. On August 29, 2003, a notice of proposed rulemaking (REG–106486–98, 2003–42 I.R.B. 853) relating to the taxation of nonfunctional currency denominated contingent payment debt instruments was published in the **Federal Register** (68 FR 51944). No public hearing was requested or held. One written comment responding to the notice of proposed rulemaking was received. After consideration of this comment, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Summary of Comments

Treasury and the IRS received one comment letter in response to the notice of proposed rulemaking. The issues raised in that comment letter are addressed below.

1. *Exceptions Described in §1.1275–4(a)(2)*

The comment letter notes that in describing instruments subject to §1.988–6 by reference to §1.1275–4(b)(1), it was unclear whether the exceptions set forth in §1.1275–4(a)(2) applied to instruments described in §1.988–6(a)(1).

It was intended to be implicit from the reference to §1.1275–4(b)(1) that debt instruments excluded from the application of §1.1275–4 by reason of §1.1275–4(a)(2) (other than by reason of being subject to section 988) are similarly excluded from §1.988–6. Nevertheless, the final regulations have been revised to make explicit that §1.988–6 applies only to debt instruments to which §1.1275–4 would otherwise apply (not taking into account the exclusion for debt instruments that are subject to section 988).

2. *Multicurrency Debt Instruments With Related Hedges*

The comment letter expresses concern that it may be possible to structure arrangements to avoid the original issue discount (OID) rules using a multicurrency debt instrument that has a nonfunctional currency as the predominant currency and partial hedges of that instrument. That is, it may be possible to closely replicate the economic attributes of a dollar denominated instrument with OID through a combination of a multicurrency instrument without OID and a partial hedge of that instrument. The comment letter suggests that §1.988–5(a) would not apply in such a case, because the hedge would not be a complete hedge of all payments.

Treasury and the IRS believe that an anti-abuse rule is appropriate to prevent the potential abuse described above. Accordingly, an anti-abuse rule applicable to debt instruments subject to section 988 is included in §1.988–2(b)(18). This anti-abuse rule is patterned after the anti-abuse rule contained in §1.1275–2(g) and permits the Commissioner to apply or depart from the applicable regulations as necessary or appropriate to achieve a reasonable result. No inference is intended as to how the Commissioner may apply the anti-abuse rule contained in §1.1275–2(g) to nonfunctional currency denominated debt instruments.

In addition, Treasury and the IRS believe that §1.988–2(f) may be applied in the situation described. Furthermore, Treasury and the IRS note that under §1.988–5(a)(8)(iii) the Commissioner can integrate a foreign currency denominated debt instrument with a partial hedge of that instrument.

3. *Multicurrency Debt Instrument—Determination of Predominant Currency*

The comment letter proposes the use of a special anti-abuse rule in the case where the net present value of all payments in, or determined with respect to, the predominant currency of a multicurrency instrument does not exceed 50 percent of the present value of all payments. The letter requests that, in such a case, the comparable yield be determined on a synthetic basis by reference to the weighted average of the comparable yields in each component currency rather than by reference to the predominant currency. There are two stated rationales for this request. First, the holder could avoid accrual of OID if a multicurrency contingent payment debt instrument's predominant currency is a currency with a low interest rate and the other currencies in which payments are denominated or with respect to which payments are determined are highly inflationary currencies (but not hyperinflationary currencies). Second, if the predominant low interest rate currency in such an instrument is the U.S. dollar and the issuer is foreign, a holder's gain upon disposition of the instrument would be characterized as foreign source interest income rather than as U.S. source foreign currency gain.

Treasury and the IRS agree that the letter has identified an issue to be addressed. However, Treasury and the IRS believe the proposed solution of creating a synthetic yield (and presumably a synthetic currency to measure currency gain or loss) is overly complex and would be difficult to administer. Instead, Treasury and the IRS have added a special rule that applies if there is no single currency for which the net present value in functional currency of all payments denominated in, or determined by reference to, that currency is greater than 50 percent of the total value of all payments. In such a case, if the discount rate attributable to the currency that would otherwise be the predominant currency differs by 10 percentage points or more from the discount rate attributable to any other currency in which payments are denominated or with respect to which payments are determined, the Commissioner can determine the predominant currency under any reasonable method.

4. *Integrated Debt Instruments*

The comment letter requests clarification that §1.988–6 does not apply to transactions that are composed of a nonfunctional currency contingent payment debt instrument (or a multicurrency debt instrument) and a qualified hedge and that are subject to the integration rules of §1.988–5. Treasury and the IRS believe that the proposed regulations are clear on this point, because §1.988–5(a)(5)(i) provides that a taxpayer may treat a debt instrument and a hedge as an integrated economic transaction only if, among other things, all the contingent features of an instrument are fully hedged such that the synthetic debt instrument resulting from integration is not a contingent payment instrument. Accordingly, no change has been made in the final regulations regarding this issue.

5. *Alternative Payment Schedule and Fixed Yield Rules*

Section 1.1275–4(a)(2)(iii) provides that the contingent payment debt instrument rules in §1.1275–4 do not apply to a debt instrument subject to §1.1272–1(c) (a debt instrument that provides for certain alternative payment schedules) or §1.1272–1(d) (a debt instrument that provides for a fixed yield). The comment letter requests that the final regulations clarify that, for purposes of applying §§1.1272–1(c) and 1.1272–1(d) to a nonfunctional currency denominated debt instrument, the yield of the instrument be determined in the instrument's denomination currency, rather than in the taxpayer's functional currency. Treasury and the IRS believe that it is clear under §1.988–2(b)(2)(ii)(A) (determinations regarding OID in a nonfunctional currency denominated debt instrument are made in the currency of the debt instrument) that these provisions are applied by using the debt instrument's denomination currency. Accordingly, no change has been made in the final regulations regarding this issue.

6. *Predominant Currency of a Multicurrency Debt Instrument is the Same as the Taxpayer's Functional Currency*

The comment letter requests that the final regulations clarify that if the predominant currency of a multicurrency debt instrument is the taxpayer's functional currency, then section 988 does not apply to that instrument. Treasury and the IRS believe that §1.988–6(d)(4) of the proposed regulations is clear on this point. Accordingly, no further clarification is made in the final regulations.

7. *Other Regulatory Provisions*

The comment letter requests that the final regulations clarify that debt instruments subject to §1.988–6 be treated for purposes of other regulations as if they were subject to §1.1275–4. Section 1.988–6 provides that the rules of §1.1275–4 apply to debt instruments subject to §1.988–6, except as otherwise provided in §1.988–6. Accordingly, a reference to a debt instrument subject to §1.1275–4 will also refer to a debt instrument subject to §1.988–6, unless otherwise provided in §1.988–6. Treasury and the IRS therefore believe that no further clarification is necessary.

8. *Netting Currency Gain or Loss With Other Gain or Loss Upon a Disposition of the Instrument*

In response to a request in the preamble to the proposed regulations for comments regarding netting, the comment letter proposes that foreign currency gain or loss be netted with other gain or loss on the disposition of a debt instrument. Treasury and the IRS are concerned about this type of netting in the context of foreign currency contingent payment debt instruments. Depending on the particular terms of such an instrument, a change in value due to a contingency may be recognized for tax purposes in a year prior to the recognition of foreign currency gain or loss upon disposition of the instrument or may be recognized concurrently with the recognition of foreign currency gain or loss upon disposition. Treasury and the IRS therefore have concluded that netting is not appropriate in the context of foreign currency contingent payment debt instruments.

9. *Tax Exempt Foreign Currency Contingent Payment Debt Instruments*

In response to a request in the preamble to the proposed regulations for comments regarding tax exempt foreign currency contingent payment debt instruments, the comment letter requests certain modifications to §1.1275–4(d)(3) to take into account the policy considerations underlying §1.988–3(c). Treasury and the IRS appreciate these comments but believe the matter deserves more careful study before any regulations specifically addressing tax exempt foreign currency contingent payment debt instruments can be issued.

10. *Multicurrency Debt Instruments With no Non-Currency Contingencies*

In response to the request for comments contained in the preamble to the proposed regulations, the comment letter requests that all gain or loss on a sale of a multicurrency debt instrument that has no non-currency contingencies be characterized wholly as foreign currency gain or loss. Treasury and the IRS are concerned that such treatment would differ inappropriately from the treatment of gain or loss in respect of a contingent payment debt instrument that has currency contingencies and non-currency contingencies. Accordingly, no change has been made in the final regulations regarding this issue.

Effect on Other Documents

The following publications are obsolete with regard to debt instruments issued on or after October 29, 2004:

Announcement 99–76, 1999–2 C.B. 223.

Special Analyses

It has been determined that this final regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few, if any, small entities issue or hold foreign currency denominated contingent payment debt instruments. Generally, it is expected that the only domestic holders of these instruments will likely be financial institutions, investment banking firms, investment funds, and other sophisticated investors, due to the foreign currency risk and other contingencies inherent in these instruments. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to 26 U.S.C. 7805(f), the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Milton Cahn of the Office of the Associate Chief Counsel (International). 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 parts 1 and 602 are 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 1.988–0 is amended as follows:

1. The introductory text is revised.

2. Entries are added for §§1.988–2(b)(18), 1.988–2(h) and 1.988–6.

The revision and additions read as follows:

§1.988–0 Taxation of gain or loss from a section 988 transaction; Table of contents

This section lists captioned paragraphs contained in §§1.988–1 through 1.988–6.

* * * * *

§1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(18) Interaction of section 988 and §1.1275–2(g).

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(h) Timing of income and deductions from notional principal contracts.

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§1.988–6 Nonfunctional currency contingent payment debt instruments.

(4) Treatment of payments in currencies other than the denomination currency.

(e) Instruments issued for nonpublicly traded property.

(1) Applicability.

(2) Separation into components.

(3) Treatment of components consisting of one or more noncontingent payments in the same currency.

(4) Treatment of components consisting of contingent payments.

(5) Basis different from adjusted issue price.

(6) Treatment of holder on sale, exchange, or retirement.

(f) Rules for nonfunctional currency tax exempt obligations described in §1.1275–4(d).

(g) Effective date.

Par. 3. Section 1.988–2 is amended by:

1. Adding the text of paragraph (b)(2)(i)(B)(*1*).

2. Revising paragraph (b)(2)(i)(B)(*2*).

3. Adding the text of paragraph (b)(18).

The additions and revision read as follows:

§1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) * * * (*1*) *Operative rules*. See §1.988–6 for rules applicable to contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

(*2*) *Certain instruments are not contingent payment debt instruments*. For purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder, a debt instrument does not provide for contingent payments merely because the instrument is denominated in, or all payments of which are determined with reference to, a single nonfunctional currency. See §1.988–6 for the treatment of nonfunctional currency contingent payment debt instruments.

* * * * *

(18) *Interaction of section 988 and §1.1275–2(g)*—(i) *In general*. If a principal purpose of structuring a debt instrument subject to section 988 and any related hedges is to achieve a result that is unreasonable in light of the purposes of section 163(e), section 988, sections 1271 through 1275, or any related section of the Internal Revenue Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (b)(18) applies to a multi-currency debt instrument and a hedge or hedges, the Commissioner can wholly or partially integrate transactions or treat portions of the debt instrument as separate instruments where appropriate. See also §1.1275–2(g).

(ii) *Unreasonable result*. Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. Another significant fact is whether the result is obtainable without the application of §1.988–6 and any related provisions (*e.g.*, if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(iii) *Effective date*. This paragraph (b)(18) shall apply to debt instruments issued on or after October 29, 2004.

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Par. 4. Section 1.988–6 is added to read as follows:

§1.988–6 Nonfunctional currency contingent payment debt instruments.

(a) *In general*—(1) *Scope*. This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1) and to which §1.1275–4(a) would otherwise apply if the debt instrument were denominated in the taxpayer's functional currency. Except as provided by the rules in this section, the rules in §1.1275–4 (relating to contingent payment debt instruments) apply to the following instruments—

(i) A debt instrument described in §1.1275–4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1) (*e.g.*, the instrument is issued for non-publicly traded property).

(2) *Exception for hyperinflationary currencies*—(i) *In general*. Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in §1.985–1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument's economic substance.

(ii) *Discretion as to method*. If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument's economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of §1.988–2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) *Instruments described in paragraph (a)(1)(i) of this section*—(1) *In general*. Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in §1.1275–4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph (b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer's functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument. Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described in paragraph (a)(1)(iv) of this section.

(2) *Application of noncontingent bond method*—(i) *Accrued interest*. Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in the denomination currency of the instrument by applying the noncontingent bond method, set forth in §1.1275–4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in §1.1275–4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in §1.1275–4(b)(4)(i) shall be the rate described in §1.1274–4(d) with respect to the denomination currency.

(ii) *Net positive and negative adjustments*. Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(6) (and §1.1275–4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in the denomination currency, the excess is treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder's total interest inclusions on the debt instrument (determined in the denomination currency) exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer's total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year's interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C), in the denomination currency.

(iii) *Adjusted issue price*. The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument's issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) *Adjusted basis*. The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the taxpayer's functional currency. In accordance with those rules, a holder's basis in the debt instrument is increased by the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) *Amount realized*. The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) *Treatment and translation of amounts determined under noncontingent bond method*—(i) *Accrued interest*. The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer's functional currency at the average exchange rate, as described in §1.988–2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in §1.988–2(b)(2)(iii)(B).

(ii) *Net positive and negative adjustments*—(A) *Net positive adjustments*. A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the taxpayer's functional currency at the spot rate on the last day of the taxable year in which the adjustment is taken into account under §1.1275–4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) *Net negative adjustments*. A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer's functional currency under the following rules:

(*1*) The amount of a net negative adjustment determined in the denomination currency that reduces the current year's interest in that currency shall first reduce the current year's accrued but unpaid interest, and then shall reduce the current year's interest which was accrued and paid. No translation is required.

(*2*) The amount of a net negative adjustment treated as ordinary income or loss under §1.1275–4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(*3*) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(*1*) and (*2*) of this section is attributable to interest accrued and paid in prior taxable years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(*4*) Any amount of the net negative adjustment remaining after application of paragraphs (b)(3)(ii)(B)(*1*), (*2*) and (*3*) of this section is a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to interest reduces the holder's amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in §1.1275–4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) *Adjusted basis*—(A) *In general*. Except as otherwise provided in this paragraph and paragraph (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under §1.1275–4(b)(7)(iii) into functional currency as follows:

(*1*) The holder's initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(*2*) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(*3*) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder's basis in the instrument under §1.1275–4(b)(7)(iii) are translated as follows:

(*i*) The payment first is attributable to the most recently accrued interest to which prior amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(*ii*) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(*3*)(*i*) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) *Exception for interest reduced by a negative adjustment carryforward*. Solely for purposes of this §1.988–6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) *Amount realized*—(A) *Instrument held to maturity*—(*1*) *In general*. With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer's holding period as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(2) *Subsequent purchases at discount and fixed but deferred contingent payments*. For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to adjusted basis under paragraph (b)(7) or (8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) *Sale, exchange, or unscheduled retirement*—(*1*) *Holder*. In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder's amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (*i.e.*, any excess of the sale price over the holder's basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(*2*) *Issuer*. In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) *Effect of negative adjustment carryforward with respect to the issuer*. Any amount of negative adjustment carryforward treated as ordinary income under §1.1275–4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) *Determination of gain or loss not attributable to foreign currency*. A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in §1.1275–4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) *Determination of foreign currency gain or loss*—(i) *In general*. Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of §1.988–2(b).

(ii) *Foreign currency gain or loss attributable to accrued interest*. The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount the amount determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) *Principal*. The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the holder, if later, acquired. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) *Payment ordering rules*—(A) *In general*. Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(*1*) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(*2*) Any amount remaining after applying paragraph (b)(5)(iv)(A)(*1*) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts have not already been attributed to such period.

(*3*) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(*1*) and (*2*) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) *Special rule for sale or exchange or unscheduled retirement*. Payments made or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) *Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest*. A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) *Source of gain or loss*. The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.988–4. Consistent with the rules of §1.1275–4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.1275–4(b)(9)(iv). The source of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.865–1(b)(2).

(7) *Basis different from adjusted issue price*—(i) *In general*. The rules of §1.1275–4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument's adjusted issue price.

(ii) *Determination of basis*. If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder's initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) *Purchase price greater than adjusted issue price*. If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(B), reasonably allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) *Purchase price less than adjusted issue price*. If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) *Fixed but deferred contingent payments*. In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of §1.1275–4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under §1.1275–4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) *Examples*. The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

Example 1. Treatment of net positive adjustment—(i) *Facts*. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and §1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule, as constructed under the rules of §1.1275–4(b), provides for a single payment of £1210 on December 31, 2006 (consisting of a noncontingent payment of £975 and a projected payment of £235). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00 = $1.00
Dec. 31, 2005	£1.00 = $1.10
Dec. 31, 2006	£1.00 = $1.20

Accrual period	Average rate (pounds to dollars)
2005	£1.00 = $1.05
2006	£1.00 = $1.15

(ii) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2005 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($1.05 x £100 = $105). Accordingly, Z has interest income in 2005 of $105.

(B) *Adjusted issue price and basis*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £110 of interest on the debt instrument for 2006 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £110 at the average exchange rate for the accrual period ($1.15 x £110 = $126.50). Accordingly, Z has interest income in 2006 of $126.50.

(B) *Effect of net positive adjustment*. The payment actually made on December 31, 2006, is £1300, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of £90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the £90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on the last day of the year ($1.20 x £90 = $108). Accordingly, Z has a net positive adjustment of $108 resulting in a total interest inclusion for 2006 of $234.50 ($126.50 + $108 = $234.50).

(C) *Adjusted issue price and basis*. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized*. Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1210 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £1000 of the £1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Z's total amount realized is $1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss*. Under paragraph (b)(5) of this section, Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), £1210. The amount of recognized foreign currency gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is $15 [£100 x ($1.20 - $1.05)]. With respect to interest accrued in 2006, the foreign currency gain equals $5.50 [£110 x ($1.20 - $1.15)]. With respect to principal, the foreign currency gain is $200 [£1000 x ($1.20 - $1.00)]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $220.50.

(F) *Source*. Z has interest income of $105 in 2005, interest income of $234.50 in 2006 (attributable to £110 of accrued interest and the £90 net positive adjustment), and a foreign currency gain of $220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 2. *Treatment of net negative adjustment*—(i) *Facts*. Assume the same facts as in *Example 1*, except that Z receives £975 at maturity instead of £1300.

(ii) *Treatment in 2005*. The treatment of the debt instrument in 2005 is the same as in Example 1. Thus, Z has interest income in 2005 of $105. On January 1, 2006, the adjusted issue price of the debt instrument is £1100, and Z's adjusted basis in the instrument is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($1.15 x £110 = $126.50).

(B) *Effect of net negative adjustment*. The payment actually made on December 31, 2006, is £975, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section, the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.05). Accordingly, Z has an ordinary loss of $105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis*. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized*. Even though Z receives £975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated as receiving £1185 (£1210 - £25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £975 of the £1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $975. Z's amount realized is $1206.50 ($105 + $126.50 + $975 = $1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $25 on retirement of the instrument ($1206.50 - $1231.50 = -$25).

(E) *Foreign currency gain or loss*. Z recognizes foreign currency gain with respect to the consideration actually received at maturity, £975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $195 [£975 x ($1.20 - $1.00)].

(F) *Source*. In 2006, Z has an ordinary loss of $105, a capital loss of $25, and a foreign currency gain of $195. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $105 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $195 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 3. Negative adjustment and periodic interest payments —(i) *Facts*. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00 = $1.00
June 30, 2005	£1.00 = $1.20
Dec. 31, 2005	£1.00 = $1.40
June 30, 2006	£1.00 = $1.60
Dec. 31, 2006	£1.00 = $1.80

Accrual period	Average rate (pounds to dollars)
Jan. - June 2005	£1.00 = $1.10
July - Dec. 2005	£1.00 = $1.30
Jan. - June 2006	£1.00 = $1.50
July - Dec. 2006	£1.00 = $1.70

(ii) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £50 of interest on the debt instrument for the January-June accrual period (issue price of £1000 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £50 at the average exchange rate for the accrual period ($1.10 x £50 = $55.00). Similarly, Z accrues £51 of interest in the July-December accrual period [(£1000 + £50 - £30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.30 x £51 = $66.30). Accordingly, Z accrues $121.30 of interest income in 2005.

(B) *Adjusted issue price and basis*—(*1*) *January-June accrual period*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is £1020 (£1000 + £50 - £30 = £1020). For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.10 x £50 = $55). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.10 x £30 = $33). Accordingly, Z's adjusted basis as of July 1, 2005, is $1022 ($1000 + $55 - $33).

(*2*) *July-December accrual period*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is £1041 (£1020 + £51 - £30 = £1041). For purposes of determining Z's dollar basis in the debt instrument, the $1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.30 x £51 = $66.30). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.30 x £30 = $39). Accordingly, Z's adjusted basis as of January 1, 2006, is $1049.30 ($1022 + $66.30 - $39).

(C) *Foreign currency gain or loss*. Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot rate on the date the £30 payment was made and the average exchange rate for the accrual period during which the interest accrued. Accordingly, Z recognizes $3 of foreign currency gain on the January-June interest payment [£30 x ($1.20 - $1.10)], and $3 of foreign currency gain on the July-December interest payment [£30 x ($1.40 - $1.30)]. Z recognizes in 2005 a total of $6 of foreign currency gain.

(D) *Source*. Z has interest income of $121.30 and a foreign currency gain of $6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is £52.05 (adjusted issue price of £1041 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £52.05 at the average exchange rate for the accrual period ($1.50 x £52.05 = $78.08). Similarly, Z accrues £53.15 of interest in the July-December accrual period [(£1041 + £52.05 - £30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.70 x £53.15 = $90.35). Accordingly, Z accrues £105.20, or $168.43, of interest income in 2006.

(B) *Effect of net negative adjustment*. The payment actually made on December 31, 2006, is £981.00, rather than the projected £1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of £105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) *Adjusted issue price and basis*—(*1*) *January-June accrual period*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2006, the adjusted issue price of the debt instrument is £1063.05 (£1041 + £52.05 - £30 = £1063.05). For purposes of determining Z's dollar basis in the debt instrument, the $1049.30 adjusted basis is increased by the £52.05 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.50 x £52.05 = $78.08). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.50 x £30 = $45). Accordingly, Z's adjusted basis as of July 1, 2006, is $1082.38 ($1049.30 + $78.08 - $45).

(*2*) *July-December accrual period*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is £1086.20 (£1063.05 + £53.15 - £30 = £1086.20). For purposes of determining Z's dollar basis in the debt instrument, the $1082.38 adjusted basis is increased by the £53.15 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.70 x £53.15 = $90.36). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.70 x £30 = $51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is $1121.74 ($1082.38 + $90.36 - $51).

(D) *Amount realized*. Even though Z receives £981.00 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1086.20 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £20 of the £1086.20 (representing the interest accrued in the January-June 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.10), resulting in an amount realized of $22; £21 of the £1086.20 (representing the interest accrued in the July-December 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.30), resulting in an amount realized of $27.30; £22.05 of the £1086.20 (representing the interest accrued in the January-June 2006 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $33.08; £23.15 of the £1086.20 (representing the interest accrued in the July 1-December 31, 2006, accrual period, less the £30 interest payment) is translated into dollars at the rate at which it was accrued (£1 = $1.70), resulting in an amount realized of $39.36; and £1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Accordingly, Z's total amount realized is $1121.74 ($22 + $27.30 + $33.08 + $39.36 + $1000), the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss*. Z recognizes foreign currency gain with respect to each £30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(*3*) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $18 of foreign currency gain on the January-June 2006 interest payment [£30 x ($1.60 - $1.00)], and $24 of foreign currency gain on the July-December 2006 interest payment [£30 x ($1.80 - $1.00)]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, £981.00. The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the £30 payments), the foreign currency gain is $14 [£20 x ($1.80 - $1.10)]. With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the £30 payments), the foreign currency gain is $10.50 [£21 x ($1.80 - $1.30)]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is $752 [£940 x ($1.80 - $1.00)]. Thus, Z recognizes a foreign currency gain of $42 on receipt of the two £30 payments in 2006, and $776.50 ($14 + $10.50 + $752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of $818.50.

(F) *Source*. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 4. Purchase price greater than adjusted issue price—(i) *Facts*. On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of §1.1275–4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
July 1, 2005	£1.00 = $1.00
Dec. 31, 2006	£1.00 = $2.00

Accrual period	Average rate (pounds to dollars)
July 1 - December 31, 2005	£1.00 = $1.50
January 1 - June 30, 2006	£1.00 = $1.50
July 1 - December 31, 2006	£1.00 = $1.50

(ii) *Initial basis*. Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is $1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (£1 = $1).

(iii) *Allocation of purchase price differential*. Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of £1161.76 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ($1.50 x £59.54 = $89.31). Accordingly, Z has interest income in 2005 of $89.31.

(B) *Adjusted issue price and basis*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1221.30 (£1161.76 + £59.54). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the $1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is $1494.31 [$1405 + (£59.54 x $1.50)].

(v) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of £1221.30 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ($1.50 x £62.59 = $93.89). Similarly, Z accrues £65.80 of interest in the July-December 2006 accrual period [(£1221.30 + £62.59) x 10.25 percent/2], which is translated at the average exchange rate for the accrual period ($1.50 x £65.80 = $98.70). Accordingly, Z accrues £128.39, or $192.59, of interest income in 2006.

(B) *Effect of positive and negative adjustments*—(*1*) *Offset of positive adjustment*. The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 (£50.30 - £243.24 = -£192.94) for 2006.

(*2*) *Offset of accrued interest*. Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.50). Accordingly, Z has an ordinary loss of $89.31 in 2006. The remaining £5.01 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis*—(*1*) *January-June accrual period*. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89 (£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is $1588.20 ($1494.31 + $93.89).

(*2*) *July-December accrual period*. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued interest for July-December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1686.90 ($1588.20 plus $98.70 of accrued interest for July-December).

(*3*) *Adjustment to basis upon contingent payment*. Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = $1). Accordingly, Z's adjusted basis in the debt instrument at maturity is $1443.66 ($1686.90 - $243.24).

(D) *Amount realized*. Even though Z receives £1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 - £5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $89.31; £62.59 of the £1344.69 (representing the interest accrued in January-June 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $93.89; £65.80 of the £1344.69 (representing the interest accrued in July-December 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $98.70; and £1156.76 of the £1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1156.76. Z's amount realized is $1438.66 ($89.31 + $93.89 + $98.70 + $1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $5 on retirement of the instrument ($1438.66 - $1443.66 = -$5).

(E) *Foreign currency gain or loss*. Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of $1400 [£1400 x ($2.00 - $1.00)].

(F) *Source*. Z has an ordinary loss of $89.31, a capital loss of $5, and a foreign currency gain of $1400. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $89.31 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $5 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 5. Sale of an instrument with a negative adjustment carryforward—(i) *Facts*. On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is £50. On December 30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003	£1.00 = $1.00
Dec. 31, 2005	£1.00 = $2.00
Dec. 30, 2006	£1.00 = $2.00

Accrual period	Average rate (pounds to dollars)
January 1 - December 31, 2004	£1.00 = $2.00
January 1 - December 31, 2005	£1.00 = $2.00
January 1 - December 31, 2006	£1.00 = $2.00

(ii) *Treatment in 2004*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2004 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($2.00 x £100 = $200). Accordingly, Z has interest income in 2004 of $200.

(B) *Adjusted issue price and basis*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is $1200 ($1000 + $200).

(iii) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($2.00 x £110 = $220).

(B) *Effect of net negative adjustment*. The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section, the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $2.00). Accordingly, Z has an ordinary loss of $200 in 2005. The remaining £50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis*. Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006, is £900, *i.e.*, the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis on January 1, 2006, is Z's adjusted basis on January 1, 2005 ($1200), increased by the functional currency amount of interest accrued in 2005 ($220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ($1200 + $220 = $1420), is decreased by $520 ($220 + $200 + $100 = $520). Z's adjusted basis on January 1, 2006, is therefore, $900.

(D) *Foreign currency gain or loss*. Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $50 of foreign currency gain on the £50 payment. [($2.00 - $1.00) x £50 =$50]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2006 (adjusted issue price of £900 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ($2.00 x £90 = $180). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of $180.

(B) *Effect of net negative adjustment*. The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative adjustment carryforward, Z will accrue $80 of interest income. [(£90-£50) x $2.00 = $80]

(C) *Adjusted issue price*. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) *Adjusted basis*. For purposes of determining Z's dollar basis in the debt instrument, Z's $900 adjusted basis on January 1, 2006, is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) of this section the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, *i.e.*, £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, *i.e.*, £1.00 = $1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is $1030 ($900 + $50 + $80).

(E) *Amount realized*. Z's amount realized in denomination currency is £940, *i.e.*, the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(*1*) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also is translated by reference to the principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is $940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of $90 on the sale of the debt instrument ($1030 basis - $940 amount realized). Under paragraph (b)(4) of this section and §1.1275–4(b)(8), $80 of the loss is characterized as ordinary loss, and the remaining $10 of loss is characterized as capital loss. Under §§1.988–6(b)(6) and 1.1275–4(b)(9)(iv) the $80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§1.988–6(b)(6) and 1.865–1(b)(2) the $10 capital loss is also allocated to the interest income from the debt instrument.

(F) *Foreign currency gain or loss*. Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of $940. [($2.00-$1.00) x £940]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) *Multicurrency debt instruments*—(1) *In general*. Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) *Determination of denomination currency*—(i) *In general*. The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. Except as otherwise provided in paragraph (d)(2)(ii) of this section, the predominant currency of the instrument shall be the currency with the greatest value determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies).

(ii) *Difference in discount rate of greater than 10 percentage points*. This §1.988–6(d)(2)(ii) applies if no currency has a value determined under paragraph (d)(2)(i) of this section that is greater than 50% of the total value of all payments. In such a case, if the difference between the discount rate in the denomination currency otherwise determined under (d)(2)(i) of this section and the discount rate determined under paragraph (d)(2)(i) of this section with respect to any other currency in which payments are made (or determined by reference to) pursuant to the instrument is greater than 10 percentage points, then the Commissioner may determine the predominant currency under any reasonable method.

(3) *Issuer/holder consistency*. The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) *Treatment of payments in currencies other than the denomination currency*. For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as non-currency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under §1.1275–4(b) rather than under this section.

(e) *Instruments issued for nonpublicly traded property*—(1) *Applicability*. This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1). For example, this paragraph (e) generally applies to a contingent payment debt instrument denominated in a nonfunctional currency that is issued for non-publicly traded property. Generally the rules of §1.1275–4(c) apply except as set forth by the rules of this paragraph (e).

(2) *Separation into components*. An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of §1.1275–4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) *Treatment of components consisting of one or more noncontingent payments in the same currency*. The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under §1.1274–2(c)(2), and the test rate shall be determined under §1.1274–4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the *de minimis* rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided

in §1.988–2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) *Treatment of components consisting of contingent payments*—(i) *General rule*. A component consisting of a contingent payment shall generally be treated in the manner provided in §1.1275–4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test rate shall be determined by reference to the currency which most reasonably reflects the economic substance of the contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) *Certain delayed contingent payments*—(A) *Separate debt instrument relating to the fixed component*. The rules of §1.1275–4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of §1.988–2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) *Contingent component*. With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under §1.1275–4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the issuer or holder at the spot rate on the date the payment becomes fixed.

(5) *Basis different from adjusted issue price*. The rules of §1.1275–4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) *Treatment of a holder on sale, exchange, or retirement*. The rules of §1.1275–4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) *Rules for nonfunctional currency tax exempt obligations described in §1.1275–4(d)*—(1) *In general*. Except as provided in paragraph (f)(2) of this section, section 1.988–6 shall not apply to a debt instrument the interest on which is excluded from gross income under section 103(a).

(2) *Operative rules*. [RESERVED].

(g) *Effective date*. This section shall apply to debt instruments issued on or after October 29, 2004.

Par. 5. In §1.1275–2, paragraph (g)(1) is amended by adding a sentence at the end of the paragraph to read as follows:

§1.1275–2 Special rules relating to debt instruments.

* * * * *

(g) * * * (1) * * * See also §1.988–2(b)(18) for debt instruments with payments denominated in (or determined by reference to) a currency other than the taxpayer's functional currency.

* * * * *

Par. 6. In §1.1275–4, paragraph (a)(2)(iv) is revised to read as follows:

§1.1275–4 Contingent payment debt instruments.

(a)* * *

(2)* * *

(iv) A debt instrument subject to section 988 (except as provided in §1.988–6);

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. Section 602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read, in part, as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.988–6	1545–1831
* * * * *	

Nancy J. Jardini,
Acting Deputy Commissioner for Services and Enforcement.

Approved July 16, 2004.

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

(Filed by the Office of the Federal Register on August 27, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 30, 2004, 69 F.R. 52816)

Section 1502.—Regulations

26 CFR 1.1502–20T: Disposition or deconsolidation of subsidiary stock (temporary).

T.D. 9154

DEPARTMENT OF THE TREASURY
Internal Revenue Service (IRS)
26 CFR Part 1

Extension of Time to Elect Method for Determining Allowable Loss

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations under section 1502 of the Internal Revenue Code of 1986. The temporary regulations extend the time for consolidated groups to elect to apply a method for determining allowable loss on a disposition of subsidiary stock, and permit consolidated groups to revoke such elections. The temporary regulations affect corporations filing consolidated returns, both during and after the period of affiliation, and also affect purchasers of the stock of members of a consolidated group. The text of these temporary regulations serves as the text of the proposed regulations (REG–135898–04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective August 26, 2004.

Applicability Date: For dates of applicability, see §1.1502–20T(i)(6)(v).

FOR FURTHER INFORMATION CONTACT: Theresa Abell (202) 622–7700 or Martin Huck (202) 622–7750 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been previously reviewed and approved by the Office of Management and Budget under control number 1545–1774. Responses to this collection of information are required to obtain a benefit. This collection of information is revised by these regulations. These amended regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the revised collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1774.

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

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

Background and Explanation of Provisions

On March 7, 2002, the IRS and Treasury Department issued regulations (the 2002 regulations) permitting consolidated groups to calculate allowable loss or the basis reduction required on certain dispositions and deconsolidations of subsidiary stock by applying §1.1502–20 in its entirety, §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or §1.337(d)–2T. If a consolidated group chose to apply either §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or §1.337(d)–2T, the 2002 regulations required the consolidated group to file an election under §1.1502–20T(i) to apply the chosen provision. The 2002 regulations also included several correlative rules to address cases in which, as a result of the election, additional losses became available to the subsidiary the stock of which was disposed of.

Concurrently with the publication of these temporary regulations, the IRS and Treasury Department are publishing Notice 2004–58, 2004–39 I.R.B. 520 (September 27, 2004). That notice sets forth a method that the IRS will accept for determining whether subsidiary stock loss is disallowed and subsidiary stock basis is reduced under §1.337(d)–2T.

Given the availability of the method described in Notice 2004–58, the IRS and Treasury Department are publishing these temporary regulations to permit taxpayers to make, amend, or revoke elections under §1.1502–20T(i). These temporary regulations give taxpayers the ability to take the notice into account in choosing a method for determining allowable loss. In general these regulations allow taxpayers to elect into, or out of, the application of §1.1502–20 in its entirety, §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or §1.337(d)–2T. Under these regulations, a taxpayer that was permitted to make an election under §1.1502–20T(i), but did not previously make such an election, may make an election to apply either §1.1502–20 without regard to the duplicated loss factor, or §1.337(d)–2T. These regulations also permit a taxpayer that previously made an election to apply §1.1502–20 without regard to the duplicated loss factor to revoke the election and apply §1.1502–20 in its entirety, or to amend the election in order to apply §1.337(d)–2T. In addition, these regulations permit a taxpayer that previously made an election to apply §1.337(d)–2T to revoke the election and apply §1.1502–20 in its entirety or to amend the election in order to apply §1.1502–20 without regard to the duplicated loss factor. Finally, these regulations extend relief to acquiring groups by amending §1.1502–32T(b)(4)(b)(vii)(C) to change its date of applicability from May 7, 2003, to August 26, 2004.

If a group revokes an election to apply either §1.1502–20 without regard to the duplicated loss factor, or §1.337(d)–2T, and applies §1.1502–20 in its entirety, no election under §1.1502–20(g) will be available, even if the group had previously made an election under §1.1502–20(g) to reattribute losses of the subsidiary the stock of which was disposed of.

Pursuant to these regulations, an election under §1.1502–20T(i) must be made, amended, or revoked by including the statement required with a timely filed (including extensions) original return for a taxable year that includes any date on or before August 26, 2004, or with or as part of an amended return filed before the date the original return for the taxable year that includes August 26, 2004, is due (including any extensions). The new election or the revocation or amendment of a prior election, however, only will affect open years.

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. These temporary regulations provide relief to consolidated groups by extending the time to elect a method for determining allowable loss. The extension of time allows taxpayers to take into account concurrent guidance in choosing a method for determining allowable loss. It is necessary to provide the extension of time immediately. Accordingly, good cause is found for dispensing with prior notice and comment pursuant to 5 U.S.C. 553(b) and for dispensing with a delayed effective date pursuant to 5 U.S.C. 553(d). For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), see the notice of proposed rulemaking on this subject in this issue of the Bulletin. The IRS and Treasury Department request comments from small entities that believe they might be adversely affected by these regulations. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for the Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

The principal authors of these regulations are Theresa Abell and Martin Huck of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 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 1.1502–20T(i) is amended by:

1. Revising the first sentence of paragraph (i)(4).
2. Redesignating paragraph (i)(6) as (i)(7).
3. Adding new paragraph (i)(6).

The revision and addition read as follows:

§1.1502–20T Disposition or deconsolidation of subsidiary stock (temporary).

* * * * *

(i) * * *

(4) *Time and manner of making the election.* An election to determine allowable loss or basis reduction by applying the provisions described in paragraph (i)(2)(i) or (ii) of this section is made by including the statement required by this paragraph with or as part of any timely filed (including any extensions) original return for a taxable year that includes any date on or before August 26, 2004, or with or as part of an amended return filed before the date the original return for the taxable year that includes August 26, 2004, is due (including any extensions). * * *

* * * * *

(6) *Revocation or amendment of prior elections*—(i) *In general.* Notwithstanding anything to the contrary in this paragraph (i), if a consolidated group made an election under paragraph (i) of this section to apply the provisions described in paragraph (i)(2)(i) or (ii) of this section, the consolidated group may revoke or amend that election as provided in this paragraph (i)(6).

(ii) *Time and manner of revoking or amending an election.* An election to apply the provisions described in paragraph (i)(2)(i) or (ii) of this section is revoked or amended by including the statement required by paragraph (i)(6)(iii) of this section with or as part of any timely filed (including any extensions) original return for a taxable year that includes any date on or before August 26, 2004, or with or as part of an amended return filed before the date the original return for the taxable year that includes August 26, 2004, is due (including any extensions).

(iii) *Required statement*—(A) *Revocation.* To revoke an election to apply the provisions described in paragraph (i)(2)(i) or (ii) of this section, the consolidated group must file a statement entitled "Revocation of Election Under Section 1.1502–20T(i)." The statement must include the name and employer identification number (E.I.N.) of the subsidiary and of the member(s) that disposed of the subsidiary stock.

(B) *Amendment.* To amend an election to apply the provisions described in paragraph (i)(2)(i) or (ii) of this section, the consolidated group must file a statement entitled "Amendment of Election Under Section 1.1502–20T(i)." The statement must include the following information—

(*1*) The name and employer identification number (E.I.N.) of the subsidiary and of the member(s) that disposed of the subsidiary stock; and

(*2*) The provision the taxpayer elects to apply to determine allowable loss or basis reduction (described in paragraph (i)(2)(i) or (ii) of this section).

(iv) *Special rule.* If a consolidated group revokes an election made under paragraph (i) of this section, an election described in §1.1502–20(g) to reattribute losses will not be respected, even if such election was filed with the group's return for the year of the disposition.

(v) This paragraph (i)(6) is applicable on and after August 26, 2004.

* * * * *

Par. 3. Section §1.1502–32T(b)(4)(vii)(C) is amended by removing the language "May 7, 2003" and adding the language "August 26, 2004" each time it appears.

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

Approved August 19, 2004.

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

(Filed by the Office of the Federal Register on August 25, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 26, 2004, 69 F.R. 52419)

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26 CFR 1.1502–32T: Investment adjustments (temporary).

T.D. 9155

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Under Section 1502; Treatment of Loss Carryovers From Separate Return Limitation Years

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations under section 1502 that provide guidance regarding the treatment of certain losses available to acquired subsidiaries as a result of an election made under the section 1502 regulations. The text of these temporary regulations also serves as the text of the proposed regulations (REG–129274–04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin. These regulations apply to corporations filing consolidated returns.

DATES: *Effective Date:* These regulations are effective August 18, 2004.

Applicability Date: For dates of applicability, see §1.1502–32T(b)(4)(v)(C).

FOR FURTHER INFORMATION CONTACT: Sean McKeever at (202) 622–7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Under §1.1502–32(b)(4), if a subsidiary of a consolidated group has a loss carryover from a separate return limitation year when it becomes a member of the group, the group may make an irrevocable election to treat all or any portion of the loss carryover as expiring for all Federal income tax purposes immediately before the subsidiary becomes a member of the group. If the subsidiary was a member of another group immediately before it became a member of the group, the expiration is also treated as occurring immediately after it ceases to be a member of the prior group. Waiving losses of an acquired subsidiary is desirable in cases in which it is anticipated that the losses of the subsidiary may expire unused in that it prevents a negative basis adjustment in the stock of the subsidiary.

In March of 2002, in response to the decision of the United States Court of Appeals for the Federal Circuit in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the Treasury Department and the IRS issued guidance regarding the treatment of certain losses realized on dispositions and deconsolidations of stock of a member of a consolidated group. Those rules permitted groups to calculate allowable loss on the sale of subsidiary stock by applying §1.1502–20 in its entirety, §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or §1.337(d)–2T. If a group that made an election described in §1.1502–20(g) to reattribute to the common parent losses of the subsidiary elected to determine allowable loss by applying either §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or §1.337(d)–2T, the amount of loss treated as reattributed could be reduced. As a result, losses that were previously treated as reattributed would be treated as available for use by the subsidiary or any other group of which the subsidiary is a member, subject to any applicable limitations (*e.g.*, section 382). To prevent a purchasing consolidated group from being unfairly disadvantaged in the event that the amount of losses treated as reattributed to the common parent of the selling group were decreased and the amount of losses treated as available to the subsidiary were increased (excess losses), §1.1502–32T(b)(4)(v) was added to provide that, to the extent that the subsidiary's loss carryovers are increased by reason of an election to apply one of the alternative regimes and such loss carryovers expire, or would have been properly used to offset income, in a closed year, the purchasing group will be deemed to have made an election to treat all of such expired loss carryovers as expiring for all Federal income tax purposes immediately before the subsidiary became a member of the purchasing group (the deemed waiver rule). Accordingly, no basis reduction under §1.1502–32 would result from the expiration of, or failure to use, such losses.

The Treasury Department and the IRS have become aware that the deemed waiver rule may deny the use of excess losses in cases in which such denial was not intended, particularly in cases in which the excess losses would have been properly used to offset income in a closed year and the use of such losses in the closed year would make losses that were used in the closed year available to offset income in an open year. Accordingly, one commentator has asked that relief from the deemed waiver rule be afforded in these cases. These temporary regulations provide that relief by making the application of the deemed waiver rule optional. This relief is applicable on and after August 18, 2004. In addition, groups may apply this relief before August 18, 2004, and on and after March 7, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the treatment of certain subsidiary losses. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

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

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 — INCOME TAXES

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

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

Par. 2. Section 1.1502–32T is amended by revising paragraph (b)(4)(v)(A) and (C).

§1.1502–32T Investment adjustments (temporary).

* * *

(b) * * *

(4) * * *

(v) *Special rule for loss carryovers of a subsidiary acquired in a transaction for which an election under §1.1502–20T(i)(2) is made*—(A) *Expired losses*. Notwithstanding §1.1502–32(b)(4)(iv), unless a group otherwise chooses, to the extent that S's loss carryovers are increased by reason of an election under §1.1502–20T(i)(2) and such loss carryovers expire or would have been properly used to offset income in a taxable year for which the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which S receives the notification described in §1.1502–20T(i)(3)(iv) and at all times thereafter, the group will be deemed to have made an election under §1.1502–32(b)(4) to treat all of such loss carryovers as expiring for all Federal income tax purposes immediately before S became a member of the consolidated group. A group may choose not to apply the rule of the previous sentence to all of such loss carryovers of S by taking a position on an original or amended tax return for each relevant taxable year that is consistent with having made such choice.

* * *

(C) *Effective date*. Paragraph (b)(4)(v)(A) of this section is applicable on and after August 18, 2004. Groups, however, may apply paragraph (b)(4)(v)(A) of this section before August 18, 2004, and on and after March 7, 2002. Otherwise, see paragraph (b)(4)(v)(A) of §1.1502–32. Paragraph (b)(4)(v)(B) of this section is applicable on and after March 7, 2002.

* * * * *

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

Approved July 29, 2004.

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

(Filed by the Office of the Federal Register on August 17, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 18, 2004, 69 F.R. 51175)

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rates Update

Notice 2004–60

This notice provides guidance as to the corporate bond weighted average interest rate and the permissible range of interest rates specified under § 412(b)(5)(B)(ii)(II) of the Internal Revenue Code. In addition, it provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II), and the weighted average interest rate and permissible ranges of interest rates based on the 30-year Treasury securities rate.

CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

Sections 412(b)(5)(B)(ii) and 412(l)(7)(C)(i), as amended by the Pension Funding Equity Act of 2004, provide that the interest rates used to calculate current liability and to determine the required contribution under § 412(l) for plan years beginning in 2004 or 2005 must be within a permissible range based on the weighted average of the rates of interest on amounts invested conservatively in long term investment grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.

Notice 2004–34, 2004–18 I.R.B. 848, provides guidelines for determining the corporate bond weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability. That notice establishes that the corporate bond weighted average is based on the monthly composite corporate bond rate derived from designated corporate bond indices.

The composite corporate bond rate for August 2004 is 5.82 percent. Pursuant to Notice 2004–34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

The following corporate bond weighted average interest rate was determined for plan years beginning in the month shown below.

For Plan Years Beginning in: Month	Year	Corporate Bond Weighted Average	90% to 110% Permissible Range
September	2004	6.25	5.63 to 6.25

30-YEAR TREASURY SECURITIES WEIGHTED AVERAGE INTEREST RATE

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

Section 404(a)(1) of the Code, as amended by the Pension Funding Equity Act of 2004, permits an employer to elect to disregard subclause (II) of § 412(b)(5)(B)(ii) to determine the maximum amount of the deduction allowed under § 404(a)(1).

The rate of interest on 30-year Treasury securities for August 2004 is 5.06 percent. Pursuant to Notice 2002–26, 2002–1 C.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

The following 30-year Treasury rates were determined for the plan years beginning in the month shown below.

For Plan Years Beginning in: Month	Year	30-Year Treasury Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
September	2004	5.15	4.64 to 5.41	4.64 to 5.67

Drafting Information

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

Additional Relief for Certain Employee Benefit Plans as a Result of Florida Storms

Notice 2004–62

I. PURPOSE

The Internal Revenue Service, the Department of Labor's Employee Benefits Security Administration ("EBSA") and the Pension Benefit Guaranty Corporation ("PBGC") are providing relief in connection with certain employee benefit plans because of damage in Florida caused by Tropical Storm Bonnie, Hurricane Charley and Hurricane Frances ("Florida Storms"). The relief provided by this notice is in addition to the relief already provided by the Service to victims of the Florida Storms.

II. BACKGROUND

Section 412(a) of the Code and § 302(a) of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93–406 ("ERISA") provide that, in order for a plan to meet the minimum funding standards of the Code and ERISA, the plan must not have an accumulated funding deficiency as of the end of each plan year. Section 412(c)(10) of the Code and § 302(c)(10) of ERISA provide that, for purposes of satisfying the minimum funding requirements of the Code and ERISA, any contributions for a plan year made by an employer by the end of the 8½-month period following the end of such plan year are deemed to have been made on the last day of the year.

Section 412(d) of the Code and § 303 of ERISA provide for waivers of the minimum funding requirements in the event of temporary substantial business hardship. In order for a plan other than a multiemployer plan to receive such a waiver, § 412(d)(4) of the Code and § 303(d)(1) of ERISA provide that an application for such a waiver must be submitted no later than the 15th day of the 3rd month beginning after the close of the plan year for which the waiver is sought. Thus, for example, in order for a plan to receive a waiver of the minimum funding requirements for the plan year ending on June 30, 2004, the sponsor of the plan must have submitted an application by September 15, 2004.

Section 412(m)(1) of the Code and § 302(e)(1) of ERISA require that, with respect to certain plans with a funded current liability percentage of less than 100 percent, a higher rate of interest be charged on any unpaid required quarterly installments. Section 412(m)(5) of the Code and § 302(e)(5) of ERISA increase the required quarterly installments to the amount needed to prevent a liquidity shortfall (as defined in those sections). For a plan with a calendar-year plan year, the due dates for the required installments for the 2004 calendar year are April 15, 2004, July 15, 2004, October 15, 2004, and January 15, 2005.

Section 412(n)(1) of the Code and § 302(f)(1) of ERISA provide that, with respect to certain plans with a funded current liability percentage of less than 100 percent, if the required installments or any other payment required under those sections are not made to the plan before the due date for such installment or other payment, and if the aggregate unpaid balance of such installments or other payments exceeds $1,000,000, then there shall be a lien in favor of the plan. The lien may be perfected by the PBGC.

Section 7508A(b) of the Code provides that, in the case of a pension or other employee benefit plan, or any sponsor, administrator, participant, beneficiary, or other person with respect to such plan, affected by a Presidentially declared disaster or a terroristic or military action, the Secretary of the Treasury may prescribe a period of up to 1 year which may be disregarded in determining the date by which any action is required or permitted to be completed. No plan shall be treated as failing to be operated in accordance with its terms solely because the plan disregards any period by reason of such relief. Parallel provisions are in Titles I and IV of ERISA.

Under the PBGC's premium regulations, contributions may be taken into account for determining a plan's unfunded vested benefits for a premium payment year or a plan's entitlement to the full funding limit exemption from the variable-rate premium for a premium payment year if the contributions (1) are for a plan year before the premium payment year and (2) are made on or before the earlier of (a) the due date for payment of the variable-rate premium or (b) the date the variable-rate premium is paid (29 CFR §§ 4006.4(b)(2)(iv) and 4006.5(a)(5)).

III. RELIEF

For any plan that is affected by the Florida Storms (an "Affected Plan"), if the date described in § 412(c)(10) or 412(m) of the Code and § 302(c)(10) or 302(e) of ERISA for making contributions falls within the period beginning on August 11, 2004, and ending on October 14, 2004, then the date such contributions must be made is postponed to October 15, 2004. If the date described in § 412(d)(4) of the Code and § 303(d)(1) of ERISA for applying for a waiver for an Affected Plan falls within the period beginning on August 11, 2004, and ending on October 14, 2004, then the date such waiver must be applied for is postponed to October 15, 2004.

For purposes of the notice, a plan is an Affected Plan only if any of the following were located at the time of the Florida Storms in any of the Florida counties declared by the President to be eligible for individual assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act of 1988, Pub. L. No. 93–288: the principal place of business of the employer that maintains the plan (in the case of a single-employer plan, determined disregarding the rules of § 414(b) and (c) of the Code); the principal place of business of employers that employ more than 50 percent of the active participants covered by the plan (in the case of a plan covering employees of more than one employer, determined disregarding the rules of § 414(b) and (c)); the office of the plan or the plan administrator; the office of the primary recordkeeper serving the plan; or the office of the enrolled actuary or other advisor that had been retained by the plan or the employer at the time of the storms to determine the funding requirements for which the due date falls between the period beginning on August 11, 2004, and ending on October 14, 2004. For purposes of the preceding sentence, the term "office" includes only the worksite of those individuals, and the location of any records, necessary to determine the plan's funding requirements for the relevant period.

The following rule applies under Title IV of ERISA for purposes of determining a plan's unfunded vested benefits for a premium payment year or entitlement to the full funding limit exemption from the variable-rate premium for a premium payment year. For any plan for which this notice extends a date described in § 412(c)(10) of the Code and § 302(c)(10) of ERISA, contributions for any plan year before the premium payment year may be taken into account if they are made on or before the earlier of (1) the extended § 412(c)(10)/§ 302(c)(10) date under this notice or (2) the date of the plan's variable-rate premium filing (or, if applicable, amended variable-rate premium filing) for the premium payment year.

DRAFTING INFORMATION

The principal authors of this notice are James E. Holland, Jr. and Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500, between the hours of 8:30 a.m. and 6:30 p.m. Eastern Time, Monday through Friday (a toll-free number). Mr. Holland may be reached at (202) 283–9699 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross Reference to Temporary Regulations

Guidance Under Section 1502; Treatment of Loss Carryovers From Separate Return Limitation Years

REG–129274–04

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In this issue of the Bulletin, the Treasury Department and the IRS are issuing temporary regulations (T.D. 9155) providing guidance regarding the treatment of certain losses available to acquired subsidiaries as a result of an election made under the section 1502 regulations. The text of these proposed regulations also serves as the text of the temporary regulations set forth in this issue of the Bulletin. These regulations apply to corporations filing consolidated returns.

DATES: Written and electronic comments and requests for a public hearing must be received by November 16, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–129274–04), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may be delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:PA:LPD:PR (REG–129274–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at: *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–129274–04 or RIN 1545–BD57).

FOR FURTHER INFORMATION CONTACT: Concerning submission of comments or requesting a hearing, Treena Garrett, (202) 622–7180; concerning the proposed regulations, Sean McKeever, (202) 622–7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 1502 of the Internal Revenue Code (Code). The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Further, it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. 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 Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, the IRS will consider any electronic or written comments (a signed original and eight (8) copies) that the IRS timely receives. 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 a person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Sean McKeever, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department 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 1.1502–32 is amended by revising paragraph (b)(4)(v)(A) and (C).

§1.1502–32 Investment adjustments.

* * * * *

(b) * * *

(4) * * *

(v) [The text of this proposed paragraph is the same as the text of §1.1502–32T(b)(4)(v)(A) and (C) published elsewhere in this issue of the Bulletin].

* * * * *

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

(Filed by the Office of the Federal Register on August 17, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 18, 2004, 69 F.R. 51208)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Extension of Time to Elect Method for Determining Allowable Loss

REG–135898–04

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 1502 of the Internal Revenue Code of 1986. The proposed regulations extend the time for consolidated groups to elect to apply a method for determining allowable loss on a disposition of subsidiary stock, and permit consolidated groups to revoke such elections. The proposed regulations affect corporations filing consolidated returns, both during and after the period of affiliation, and also affect purchasers of the stock of members of a consolidated group. The text of the temporary regulations (T.D. 9154) published in this issue of the Bulletin serves as the text of these proposed regulations.

DATES: Written or electronic comments must be received by November 24, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–135898–04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–135898–04), 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–135898–04).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa Abell (202) 622–7700 or Martin Huck (202) 622–7750; concerning submissions of comments, Robin Jones, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 25, 2004. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation was previously approved and reviewed by the Office of Management and Budget under control number 1545–1774. The collection of information is required to allow the taxpayer to make certain elections to determine the amount of allowable loss under §1.1502–20 in its entirety, §1.1502–20 without regard to the duplicated loss factor, or §1.337(d)–2T; to allow the taxpayer to reapportion a section 382 limitation in certain cases; to allow the taxpayer to waive certain loss carryovers; and to ensure that loss is not disallowed under §1.337–2T and basis is not reduced under §1.337(d)–2T to the extent that the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset.

This collection of information is modified with respect to §§1.1502–20T and 1.1502–32T. Regarding §1.1502–20T, the collection of information also is necessary to allow the common parent of the selling group to reapportion a separate, subgroup or consolidated section 382 limitation when the acquiring group amends its §1.1502–32(b)(4) election. With respect to §1.1502–32T, the collection of information also is necessary to allow the acquiring group to amend its previous §1.1502–32(b)(4) election, so that it may use previously waived losses of its subsidiary.

The collection of information is required to obtain a benefit. The likely respondents are corporations that file consolidated income tax returns.

Estimated total annual reporting and/or recordkeeping burden: 36,720 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 18,360.

Estimated annual frequency of responses: once.

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

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

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR Part 1) relating to section 1502. The temporary regulations extend the time for consolidated groups to elect to apply a method for determining allowable loss on a disposition of subsidiary stock, and permit consolidated groups to revoke such elections. The temporary regulations affect corporations filing consolidated returns, both during and after the period of affiliation, and also affect purchasers of the stock of members of a consolidated group. The text of those regulations serves as the text for these proposed regulations. The preamble to the temporary regulations explains the amendments and these proposed regulations.

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 is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the regulations provide relief to consolidated groups by extending the time in which a group may make, or allowing a group to revoke, certain elections of methods for determining allowable loss. In addition, members of consolidated groups are generally large corporations rather than small businesses. Therefore, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Nevertheless, the IRS and Treasury Department request comments from small entities that believe they might be adversely affected by these regulations. 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 the impact of these regulations.

Comments and Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. 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 authors of these regulations are Theresa Abell and Martin Huck of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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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 1.1502–20 is amended by:

1. Revising the first sentence of paragraph (i)(4).

2. Redesignating paragraph (i)(6) as (i)(7).

3. Adding new paragraph (i)(6).

The revisions and addition read as follows:

§1.1502–20 Disposition or deconsolidation of subsidiary stock.

* * * * *

(i) * * *

(4) [The text of proposed §1.1502–20(i)(4) is the same as the text of §1.1502–20T(i)(4) published elsewhere in this issue of the Bulletin.]

* * * * *

(6) [The text of proposed §1.1502–20(i)(6) is the same as the text of §1.1502–20T(i)(6) published elsewhere in this issue of the Bulletin.]

Par. 3. Section §1.1502–32(b)(4)(vii)(C) is amended by removing the language "May 7, 2003" and adding the language "August 26, 2004" each time it appears.

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

(Filed by the Office of the Federal Register on August 25, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 26, 2004, 69 F.R. 52462)

Request for Comments on Revenue Procedure for the Staggered Remedial Amendment Period System

Announcement 2004–71

This announcement includes as an Appendix a draft revenue procedure that contains the Service's procedures for issuing determination letters under a staggered remedial amendment period system that establishes regular, five-year cycles under § 401(b) of the Internal Revenue Code (Code) for plan amendments and determination letter renewals for individually designed plans (that is, plans that have not been pre-approved) qualified under § 401(a). In addition, under this system, pre-approved plans (that is, master and prototype (M&P) and volume submitter plans) will generally have a regular, six-year remedial amendment cycle. The Service seeks public input before finalizing these procedures and invites interested persons to submit comments.

Background

The Service has maintained an Employee Plans determination letter program for many years, essentially in its present form. Under this program, the Employee Plans (EP) component of Tax Exempt and Government Entities (TE/GE) issues letters of determination regarding the qualified status of retirement plans under § 401(a) and the tax-exempt status of related trusts under § 501(a). Determination letters provide assurance to plan sponsors, participants and other interested parties that the terms of employer-sponsored retirement plans satisfy the qualification requirements of the Code. Qualified plans offer significant tax advantages to employers and participants.

In recent years, the Service has undertaken a comprehensive review of its policies and procedures for issuing determination letters on the qualified status of retirement plans. The impetus for this review was a need for the Service to strike a more effective balance in the application of its limited resources among the EP determinations, examinations, voluntary compliance and customer education and outreach programs. The current determination letter program has been subject to significant periodic fluctuations in workload as a result of legislative changes. These fluctuations make resource planning and allocation difficult and may have an overall negative effect on the administration of the various EP programs. Thus, a goal of the review of the determination letter program has been to identify improvements to the program that will result in a more level determination letter workflow. While this review is still ongoing, the Service has already made a number of significant improvements to the determination letter program. See, for example, Announcement 2001–77, 2001–2 C.B. 83.

Program Changes

This draft revenue procedure would establish a system of staggered five-year remedial amendment cycles for individually designed plans and a system of six-year amendment/approval cycles for pre-approved plans. These systems create fixed, regular cycles for the adoption of remedial plan amendments under § 401(b) and the submission of determination, opinion, and advisory letter applications.

In the case of individually designed plans, the five-year remedial amendment cycles would be staggered. In other words, different plans would have different five-year cycles. In general, a plan's five-year remedial amendment cycle would be determined with reference to the taxpayer identification number (TIN) of the employer that maintains the plan. Special rules are provided for plans maintained by more than one employer and plans maintained by multiple members of a controlled group or affiliated service group.

In the case of pre-approved plans, defined benefit plans would have a different six-year amendment/approval cycle schedule than defined contribution plans. The sponsor of a pre-approved document would be required to submit the plan for a new opinion or advisory letter according to the schedule set forth in the revenue procedure. An adopting employer that timely adopts the approved plan would be treated as having adopted the plan within the employer's six-year remedial amendment cycle. The Service will announce the deadline for timely adoption after the pre-approved documents in a cycle have been reviewed. It is expected that employers will have generally two years in which to adopt the pre-approved plans.

EGTRRA

This revenue procedure would provide that on February 1, 2006, the Service will begin to accept applications for determination letters for individually designed plans that take into account the requirements of Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16 (EGTRRA). This draft revenue procedure would also extend a plan's EGTRRA remedial amendment period as provided in the chart found in section 9.01, which is the Extension of the EGTRRA Remedial Amendment Period/Schedule of Next Five-Year Remedial Amendment Cycle.

Remedial Amendment Period

In the case of an individually designed plan, the end of the remedial amendment period for any disqualifying provision would be extended by this revenue procedure to the end of the five-year cycle in which the remedial amendment period would otherwise end.

In the case of a pre-approved plan, regular six-year amendment/approval cycles would be established. However defined contribution plans and defined benefit plans would have different six-year amendment/approval cycles. The schedule for the six-year amendment/approval cycles is found in section 14.01. Sponsors and practitioners would have until January 31 of the year that marks the end of the plan's first year of the six-year remedial amendment cycle to submit these plans timely for opinion and advisory letters. Adopting employers would have generally two years in which to timely adopt the pre-approved plans. The Service will announce the actual deadline for timely adoption of pre-approved plans.

Request for Comments

Interested persons are invited to comment on the draft revenue procedure, the issues addressed in this announcement, the staggered remedial amendment cycle, the six-year remedial amendment/approval cycle, or any other aspect of the pre-approved plan programs or the determination letter program.

Written comments should be submitted by January 3, 2005, to CC:PA:LPD:RU (Announcement 2004–71), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to CC:PA:LPD:RU (Announcement 2004–71), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW, Washington, D.C. Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov.* All comments will be available for public inspection.

Drafting Information

The principal author of this announcement is Dana A. Barry of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this announcement, 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).

APPENDIX

Draft Revenue Procedure

26 CFR 601.201: Rulings and determination letters.
(Also, Part I, §§ 401; 1.401(b)–1.)

Rev. Proc.

SECTION 1. PURPOSE

.01 This revenue procedure establishes a system of staggered remedial amendment periods under § 401(b) of the Internal Revenue Code (Code). Under this system, every individually designed plan qualified under § 401(a) will have a regular, five-year remedial amendment cycle. The cycles are staggered and spread over five-year periods. That is, the cycles commence in different years for different plans within a five-year period, so that different plans will have different cycles, but the length of the cycle — five years — is the same for every plan. The effect of this system is that plan sponsors of individually designed plans generally will need to adopt remedial amendments of disqualifying provisions, and will need to apply for new determination letters, only once every five years.

.02 In addition, under this system, every pre-approved plan (that is, every master and prototype (M&P) and volume submitter plan), will generally have a regular, six-year remedial amendment cycle. As a result, sponsors and adopters of pre-approved plans generally will need to apply for new opinion, advisory, or determination letters only once every six years. Pre-approved defined contribution plans will have different six-year cycles than pre-approved defined benefit plans. Thus, the same six-year remedial amendment cycle will apply with respect to all pre-approved defined contribution plans, and a separate six-year remedial amendment cycle will apply with respect to all pre-approved defined benefit plans.

.03 This revenue procedure provides that on February 1, 2006, the Service will begin to accept applications for determination letters for individually designed plans that take into account the requirements of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16 (EGTRRA). However, this revenue procedure also extends a plan's EGTRRA remedial amendment period as provided in the chart found in section 9.01, which is the Extension of the EGTRRA Remedial Amendment Period/Schedule of Next Five-Year Remedial Amendment Cycle. Therefore, plan sponsors may avoid unnecessarily filing two determination letter applications by waiting to file their EGTRRA determination letter applications within the twelve-month period preceding the end of the plan's EGTRRA remedial amendment period.

SECTION 2. BACKGROUND

.01 In Announcement 2004–32, 2004–18 I.R.B. 860, the Service announced its decision to implement a system of five-year staggered remedial amendment periods under § 401(b) of the Code for individually designed plans. The Service also announced that it was considering implementation of a system of six-year amendment/approval cycles for pre-approved plans. These decisions were the outcome of the Service's comprehensive review of its policies and procedures for issuing determination letters on the qualified status of retirement plans. The decisions were taken after consideration of public comments on two white papers on the future of the determination letter program which the Service published in 2001 and 2003.

.02 In Announcement 2004–33, 2004–18 I.R.B. 862, the Service published for comment a draft revenue procedure containing the procedures for issuing opinion and advisory letters for pre-approved plans. In the announcement, the Service also asked for comments on its proposal to implement a system of six-year amendment/approval cycles for pre-approved plans. After receiving favorable comments in response to Announcement 2004–33, the Service has decided to proceed with implementation of this system in conjunction with the implementation of the five-year staggered remedial amendment period system for individually designed plans. This revenue procedure implements both systems, effective with the opening of the determination, opinion, and advisory letter programs for EGTRRA.

.03 Section 401(b) of the Code provides a remedial amendment period during which a plan may be amended retroactively to comply with the Code's qualification requirements. Section 1.401(b)–1 of the Income Tax Regulations describes the disqualifying provisions that may be amended retroactively and the remedial amendment period during which retroactive amendments may be adopted. The regulations also grant the Commissioner the discretion to designate certain plan provisions as disqualifying provisions and to extend the remedial amendment period.

.04 Section 1.401(b)–1 provides that a plan that fails to satisfy the requirements of § 401(a) solely as a result of a disqualifying provision defined under § 1.401(b)–1(b) need not be amended to comply with those requirements until the last day of the remedial amendment period with respect to the disqualifying provision, provided the amendment is made retroactively effective to the beginning of the remedial amendment period. Under § 1.401(b)–1(b)(1), a disqualifying provision includes a provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan which causes the plan to fail to satisfy the requirements of the Code applicable to the qualification of the plan as of the date the plan or amendment is first made effective. Under § 1.401(b)–1(b)(3), a disqualifying provision includes a plan provision designated, at the Commissioner's discretion, as a disqualifying provision that either (i) results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements; or (ii) is integral to a qualification requirement of the Code that has been changed. For this purpose, a disqualifying provision includes the absence from a plan of a provision required by or, if applicable, integral to the applicable change in the qualification requirements of the Code, if the plan was in effect on the date the change in those requirements became effective with respect to the plan. Under § 1.401(b)–1(c)(3), the Commissioner may impose limits and provide additional rules regarding the amendments that may be made with respect to disqualifying provisions described in § 1.401(b)–1(b)(3).

.05 For a disqualifying provision of a new plan described in § 1.401(b)–1(b)(1), the remedial amendment period begins on the date the plan is put into effect and, in the case of a plan maintained by one employer, ends on the later of the due date (including extensions) for filing the employer's tax return for the taxable year in which the plan is put into effect or the last day of the plan year in which the plan is put into effect. A new plan maintained by more than one employer need not be amended until the last day of the tenth month following the last day of the plan year that includes the date the plan is put into effect.

.06 For a disqualifying provision that is an amendment to an existing plan described in § 1.401(b)–1(b)(1), the remedial amendment period begins on the earlier of the date the plan amendment is adopted or put into effect and, in the case of a plan maintained by one employer, ends on the later of the due date for filing the employer's tax return (including extensions) for the taxable year in which the amendment is adopted or effective (whichever is later) or the last day of the plan year in which the amendment is adopted or effective (whichever is later). In the case of an amendment to an existing plan maintained by more than one employer, the plan need not be amended until the last day of the tenth month following the last day of the plan year in which the amendment is adopted or effective (whichever is later).

.07 For a disqualifying provision described in § 1.401(b)–1(b)(3), the remedial amendment period begins on the date on which the change becomes effective with respect to the plan or, in the case of a provision that is integral to a qualification requirement that has been changed, the first day on which the plan is operated in accordance with the provision as amended. In the case of a plan maintained by one employer, the remedial amendment period for a disqualifying provision described in § 1.401(b)–1(b)(3) ends on the later of (1) the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the remedial amendment period begins or (2) the last day of the plan year that includes the date on which the remedial amendment period begins. A plan maintained by more than one employer need not be amended until the last day of the tenth month following the last day of the plan year in which the remedial amendment period begins.

.08 Section 1.401(b)–1(f) provides that the Commissioner may extend the remedial amendment period at his discretion.

.09 Notice 2001–42, 2001–2 C.B. 70, provides a remedial amendment period under § 401(b), ending no earlier than the end of the 2005 plan year, in which any needed retroactive remedial plan amendments for EGTRRA must be adopted (the EGTRRA remedial amendment period). The availability of the EGTRRA remedial amendment period is conditioned on the timely adoption of required good faith EGTRRA plan amendments. In general, a good faith EGTRRA plan amendment is adopted timely if it is adopted by the later of the end of the plan year that includes the effective date of the EGTRRA change or the end of the plan's GUST remedial amendment period.[1]

.10 The end of the EGTRRA remedial amendment period is also the last day on which retroactive remedial amendments may be adopted with respect to the requirements of the final regulations under § 401(a)(9) of the Code (required minimum distributions), Rev. Rul. 2001–62, 2001–2 C.B. 632 (applicable mortality table) and Rev. Rul. 2002–27, 2002–1 C.B. 925 (deemed section 125 compensation). (Except with respect to the requirements of the final § 401(a)(9) regulations for defined benefit plans, the availability of the remedial amendment period with respect to these requirements is conditioned on the adoption of plan amendments by the time specified in the applicable guidance (or, in the case of the final § 401(a)(9) regulations published on April 17, 2002, with respect to defined contribution plans, in Rev. Proc. 2002–29, 2002–1 C.B. 1176, as modified by Rev. Proc. 2003–10, 2003–1 C.B. 259)).

.11 Rev. Proc. 2004–25, 2004–16 I.R.B. 791, extends the remedial amendment period with respect to disqualifying provisions described in § 1.401(b)–1(b)(1) that are put into effect (in the case of new plans) or adopted (in the case of existing plans) after December 31, 2001, to the end of the EGTRRA remedial amendment period. The effect of Rev. Proc. 2004–25 is to ensure that plan sponsors do not need to apply for more than one determination letter during the EGTRRA remedial amendment period simply because they have put a plan into effect or adopted voluntary plan amendments after December 31, 2001. The revenue procedure does not extend any other existing plan amendment or determination letter submission deadlines, such as the deadline for adoption of good faith plan amendments for EGTRRA or the final § 401(a)(9) regulations.

.12 Notice 2001–42 and section _.__ of Rev. Proc. 2005–6, 2005–1 I.R.B. ___, provide that until further notice, determination letters will not consider and may not be relied on with respect to whether a plan satisfies the qualification requirements of the Code as amended by EGTRRA. However, an employer's ability to rely on a favorable determination letter will not be adversely affected by the timely adoption of good faith EGTRRA plan amendments.

SECTION 3. OVERVIEW

.01 This revenue procedure establishes a system of staggered five-year remedial amendment periods or cycles for individually designed plans and a system of six-year amendment/approval cycles for pre-approved plans. These systems are established pursuant to the Commissioner's authority under § 401(b) of the Code and its underlying regulations to designate plan provisions as disqualifying provisions, impose limits and conditions on plan amendments with respect to designated disqualifying provisions, and extend the remedial amendment period, and pursuant to the Commissioner's authority under § 7805(b) to establish the effective date of any rule or regulation.

.02 These systems will create fixed, regular cycles for the adoption of remedial plan amendments under § 401(b) and the submission of determination, opinion, and advisory letter applications. The plan sponsor will continue to be able to rely on a favorable determination letter for its plan provided the sponsor applies for a new letter not later than the last twelve-month period of each five-year cycle. Similarly, sponsors of pre-approved plan documents will know that they must apply for new opinion and advisory letters once every six years, and an adopter of a pre-approved plan will know that it must adopt an updated plan once every six years.

.03 In the case of individually designed plans, the five-year remedial amendment cycles are staggered. That is, different plans will have different five-year cycles, based generally on the plan sponsor's taxpayer identification number (TIN), so that the cycle for only 20 percent of plans will end in any given year. Staggering should eliminate significant fluctuations in the

[1] The term "GUST" refers to the following:

- the Uruguay Round Agreements Act, Pub. L. 103–465;
- the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353;
- the Small Business Job Protection Act of 1996, Pub. L. 104–188;
- the Taxpayer Relief Act of 1997, Pub. L. 105–34;
- the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105–206; and
- the Community Renewal Tax Relief Act of 2000, Pub. L. 106–554.

The GUST remedial amendment period generally ended on the later of February 28, 2002, or the end of a plan's 2001 plan year. However, for certain plans eligible for an extended GUST remedial amendment period under Rev. Proc. 2000–20, 2000–1 C.B. 553, the period generally ended on September 30, 2003.

numbers of determination letter applications filed from year to year. The Service believes this will be a benefit to both the Service and the employee benefits community. In the case of pre-approved plans, defined benefit plans will have a different six-year schedule than defined contribution plans. This should also benefit both the Service and the employee benefits community.

.04 Except as provided below, in the case of an individually designed plan, the end of the remedial amendment period for any disqualifying provision is extended by this revenue procedure to the end of the five-year cycle in which the remedial amendment period would otherwise end. Thus, the end of the remedial amendment period for disqualifying provisions under § 1.401(b)–1(b)(1) (that is disqualifying provisions in new plans and discretionary plan amendments) for an individually designed plan is extended to the end of the five-year cycle in which the remedial amendment period would otherwise end. Thus, if a new plan, or a discretionary plan amendment to an existing plan, contains a provision that causes the plan to fail to meet the qualification requirements under § 401(a), the plan has until the end of the five year cycle to correct that disqualifying provision provided the amendment is retroactively effective. However, there is no extension (remedial amendment period) for the adoption of a plan, or the adoption of a discretionary plan amendment (a plan amendment that is not required or integral to a plan qualification change). These are not disqualifying provisions.

.05 The revenue procedure provides a blanket disqualifying provision designation with respect to future changes in the qualification requirements of the Code. Thus, a plan provision that either results in the failure of a plan to satisfy the qualification requirements of the Code because of a change in those requirements or that is integral to a qualification requirement of the Code that has been changed will generally be a disqualifying provision. In addition, in the case of an individually designed plan, the remedial amendment period with respect to such a disqualifying provision is extended by this revenue procedure to the end of the first five-year cycle that ends at least twelve months after the change in the qualification requirements of the Code is first listed on the Cumulative List of Changes in Plan Qualification Requirements (as described below in section 10), which will be published annually by the Service. Thus, although a change in the qualification requirements of the Code may be effective before the end of one five-year cycle, a retroactive remedial amendment on account of the change may not be required to be adopted until the end of the plan's next five-year cycle. Of course, the amendment would need to be retroactively effective as of the effective date of the change.

.06 For most amendments, operational compliance with the amendment provisions beginning on the retroactive effective date is required. For example, for any amendment that is integral to a changed qualification requirement, operational compliance with the amended plan provisions beginning on the retroactive effective date of the amendment is required for the remedial amendment period to begin. In addition, plan sponsors may be required to adopt good faith amendments (as defined in Notice 2001–42) on account of a change in the qualification requirements of the Code earlier than the end of the plan sponsor's five-year cycle.

.07 The revenue procedure does not provide relief from the requirements of § 411(d)(6) for plan amendments adopted as a result of Code or guidance changes in the plan qualification requirements. Section 411(d)(6) generally prohibits a plan amendment that decreases a participant's accrued benefits or has the effect of eliminating or reducing an early retirement benefit or retirement-type subsidy, or eliminating an optional form of benefit, with respect to benefits attributable to service before the amendment. However, an amendment that eliminates or decreases benefits that have not yet accrued does not violate § 411(d)(6), provided the amendment is adopted and effective before the benefits accrue.

.08 The revenue procedure provides that the time for adopting plan amendments for guidance changes is extended to the end of the first five-year remedial amendment cycle that ends at least twelve months after the change is first listed on the Cumulative List of Changes in Plan Qualification Requirements.

.09 The revenue procedure provides that determination letters generally will be reviewed on the basis of, and may be relied on with respect to, the Cumulative List of Changes in Plan Qualification Requirements that is published in the year preceding the year in which applications may be filed. The revenue procedure also provides that determination letters will include an "expiration date," stating that the letter may not be relied on after the end of the five-year cycle. These changes to the determination letter program, along with the changes to the remedial amendment period rules described above, are designed to create a system that encourages plans to be updated and submitted for new determination letters on a regular five-year schedule.

.10 In general, a plan's five-year remedial amendment cycle is determined with reference to the TIN of the employer that maintains the plan. Special rules are provided for plans maintained by more than one employer and plans maintained by multiple members of a controlled group or affiliated service group. In addition, an election is provided for controlled groups and affiliated service groups that will allow the same five-year cycle to be applied to all plans maintained by any member of the group.

.11 If there is a change in the employer that maintains the plan, for example, because of a merger, the plan's cycle following the change is determined with reference to the TIN of the new employer. However, if this would shorten the plan's current cycle so that less than twelve months would remain, the current cycle will be extended for twelve months.

.12 The six-year amendment/approval cycles for pre-approved plans are comparable to the five-year cycles for individually designed plans. Provided the sponsor of a pre-approved document submits the plan for a new opinion or advisory letter according to the schedule set forth in the revenue procedure, an adopting employer that timely adopts the approved plan will be treated as having adopted the plan within the employer's six-year remedial amendment cycle. The Service will announce the deadline for timely adoption after the pre-approved documents have been reviewed, but it is expected that employers will generally have two years in which to adopt. The last date for timely adoption will be the end of the remedial amendment cycle with respect to all disqualifying provisions for which the remedial amendment period would otherwise end during the cycle.

.13 The revenue procedure extends a plan's EGTRRA remedial amendment period as provided in the chart found in section 9.01, which is the Extension of the EGTRRA Remedial Amendment Period/Schedule of Next Five-Year Remedial Amendment Cycle. The revenue procedure provides that applications for determination letters for individually designed plans that are filed on or after February 1, 2006, will be reviewed taking into account the requirements of EGTRRA.

PART I — INDIVIDUALLY DESIGNED PLANS

SECTION 4. ESTABLISHMENT OF FIVE-YEAR REMEDIAL AMENDMENT CYCLES FOR INDIVIDUALLY DESIGNED PLANS

.01 Beginning with the EGTRRA remedial amendment period, as herein extended, the determination of when a plan's remedial amendment period under § 401(b) of the Code ends will be based on the plan's remedial amendment cycle. In the case of an individually designed plan, the remedial amendment cycle is a five-year cycle. This Part I contains the rules and procedures for the five-year remedial amendment cycle for individually designed plans. In the case of a pre-approved plan, the remedial amendment cycle is a six-year cycle. Part II of this revenue procedure contains the rules and procedures for the six-year remedial amendment cycle for pre-approved plans.

.02 In general, a plan's five-year remedial amendment cycle is determined by reference to the last digit of the TIN of the employer that sponsors the plan. However, in particular circumstances, as described in section 5, a different rule is, or may be, used to determine a plan's five-year remedial amendment cycle.

.03 Under the general rule, a plan's five year remedial amendment cycle is determined as follows:

If the last digit of the plan sponsor's TIN is —	The plan's cycle is —
1 or 6	Cycle A
2 or 7	Cycle B
3 or 8	Cycle C
4 or 9	Cycle D
5 or 0	Cycle E

See also the chart listed below in section 9.01, which is the Extension of the EGTRRA Remedial Amendment Period/Schedule of Next Five-Year Remedial Amendment Cycle.

SECTION 5. EXCEPTIONS TO THE GENERAL RULE FOR DETERMINING A PLAN'S FIVE-YEAR REMEDIAL AMENDMENT CYCLE

.01 The following rules apply to determine the five-year remedial amendment cycle of plans maintained by more than one employer and plans maintained by employers that are part of a controlled group under § 414(b) or (c) or an affiliated service group under § 414(m).

.02 For plans that are maintained by more than one employer (that is, multiemployer and multiple employer plans), the plan's five-year remedial amendment cycle is Cycle A.

.03 For plans maintained by multiple members of a controlled group under § 414(b) or (c) or an affiliated service group under § 414(m), the plan's five year remedial amendment cycle is determined with reference to the last digit of the TIN that is or will be used to report the plan on Form 5500, *Annual Return/Report of Employee Benefit Plan*. However, see section 5.04, regarding the permitted election of a different cycle.

.04 In the case of a controlled group under § 414(b) or (c) or an affiliated service group under § 414(m), an election may be made that the five-year remedial amendment cycle for all plans maintained by any members of the group (other than multiemployer plans or multiple employer plans) will be Cycle A, or, in the case of a parent-subsidiary organization, the cycle determined by reference to the TIN of the parent. This election is to be made by the parent, in the case of a parent-subsidiary organization, or jointly by all members of the controlled or affiliated service group, in the case of any other organization. The election must list all members of the group, including each member's TIN, and all plans (other than multiemployer plans and multiple employer plans) that are maintained by each member of the group. The election is to be filed with the first determination letter application that is submitted in accordance with this revenue procedure for any plan (other than multiemployer plans and multiple employer plans) maintained by any member of the group. Once filed, the election will apply and may not be modified or revoked, except as provided below in section 6.01(3).

SECTION 6. RULES FOR DETERMINING FIVE-YEAR REMEDIAL AMENDMENT CYCLE IN CASES OF MERGER OR ACQUISITION, CHANGE IN PLAN SPONSORSHIP, OR PLAN SPIN-OFF

.01 Except as provided in section 6.02, in the case of a merger or acquisition, a change in plan sponsorship, or a plan spin-off, a plan's five-year remedial amendment cycle is determined as follows:

(1) If plans with different five-year remedial amendment cycles are merged, the five-year remedial amendment cycle of the merged plan is thereafter determined as provided in sections 4 and 5 on the basis of the TIN, controlled group status, affiliated service group status, etc., of the employer that maintains the merged plan, regardless of whether this would shorten or extend the

pre-merger five-year remedial amendment cycle of any of the plans that have merged.

(2) If a plan of an employer is acquired by another employer, the five-year remedial amendment cycle of the plan is thereafter determined as provided in sections 4 and 5 on the basis of the TIN, controlled group status, affiliated service group status, etc., of the employer that has acquired the plan, regardless of whether this would shorten or extend the pre-acquisition five-year remedial amendment cycle of the plan.

(3) If there is a change in the TIN, controlled group status, affiliated service group status, etc., of the employer that maintains a plan, the five-year remedial amendment cycle of the plan is thereafter determined as provided in sections 4 and 5 on the basis of the changed TIN, controlled group status, affiliated service group status, etc., of the employer, regardless of whether this would shorten or extend the five-year remedial amendment cycle of the plan. The change could result in the need to file a new election pursuant to section 5.04.

(4) If a portion of a plan is spun off, the five-year remedial amendment cycle of the spun-off plan is determined as provided in sections 4 and 5 on the basis of the TIN, controlled group status, affiliated service group status, etc., of the employer that maintains the spun-off plan, regardless of whether this would shorten or extend the five-year remedial amendment cycle of the plan.

.02 If, as a result of one of the transactions described in this section, a plan's current five-year remedial amendment cycle is shortened such that the period remaining in the cycle following the transaction is less than twelve calendar months, the plan's current cycle will be extended for twelve months and the next five-year cycle would be shortened accordingly. Thereafter, the plan's five-year remedial amendment cycles will be determined as provided in section 6.01. This extension does not apply to other plans of the employer that are not similarly affected.

SECTION 7. APPLICATION OF § 401(b) TO ALL FUTURE CHANGES IN QUALIFICATION REQUIREMENTS OF THE INTERNAL REVENUE CODE

Unless otherwise provided in future guidance, and subject to any future requirements with respect to the adoption of good faith plan amendments, in addition to the plan provisions designated as disqualifying provisions subject to the EGTRRA remedial amendment period as described in section 2.09, 2.10, and 2.11, a plan provision is designated as a disqualifying provision under § 1.401(b)–1(b)(3) if the provision either —

(i) results in the failure of the plan to satisfy the qualification requirements of the Internal Revenue Code by reason of a change in those requirements that is effective after December 31, 2001; or

(ii) is integral to a qualification requirement of the Internal Revenue Code that has been changed effective after December 31, 2001.

A change in a qualification requirement includes both a statutory change and a change in the requirements provided in regulations or other guidance published in the Internal Revenue Bulletin.

SECTION 8. EXTENSION OF THE REMEDIAL AMENDMENT PERIOD UNDER § 401(b) TO THE END OF THE REMEDIAL AMENDMENT CYCLE

.01 This section extends the remedial amendment periods for disqualifying provisions that would otherwise apply under § 1.401(b)–1 to the end of the remedial amendment cycle. It also extends the time for adopting certain plan amendments for changes in guidance pertaining to plan qualification requirements to the end of the remedial amendment cycle. The effect of these extensions is that plan sponsors of individually designed plans generally will not need to adopt remedial amendments of disqualifying provisions, and will not need to apply for new determination letters, more than once every five years. Plan sponsors may, however, be required to adopt good faith plan amendments for legislative or guidance changes before the end of their five-year remedial amendment cycles, with the result that plan amendments may in some cases be required more frequently than every five years.

.02 The remedial amendment period for a disqualifying provision described in § 1.401(b)–1(b)(1) is extended to the end of the plan's five-year remedial amendment cycle in which the remedial amendment period with respect to the disqualifying provision would otherwise end.

For the following examples, please refer to the chart found in section 9.01.

Example 1: The last digit of Employer A's TIN is 7. Employer A adopts a new plan, Plan X on January 1, 2006. The cycle for Plan X is Cycle B. The tax year of Employer A and the plan year of Plan X is the calendar year. Under § 1.401(b)–1 of the regulations, the initial remedial amendment period (RAP) would end on the later of the due date (including extensions) for filing Employer A's tax return for the taxable year in which Plan X is put into effect or the last day of the plan year in which Plan X is put into effect (that is, 2006). The initial RAP is extended to the end of the 5-year RAP cycle in which the RAP would have otherwise ended under § 1.401(b)–1. The initial RAP for Plan X therefore ends January 31, 2008. Any retroactive remedial amendments required for Plan X including EGTRRA amendments must be adopted by January 31, 2008, unless an application for a determination letter is submitted by that date. The plan would be retroactively effective to the first day Employer A adopted Plan X in 2006. The subsequent 5-year RAP cycles end on January 31, 2013, January 31, 2018, etc.

Example 2: Same facts as Example 1, except that Employer A, a C corporation, later adopts a discretionary plan amendment to Plan X that is both adopted and effective on January 1, 2013. The amendment results in a disqualifying provision. The RAP under § 1.401(b)–1 would end on the later of the due date for filing Employer A's tax return (including extensions) for the taxable year in which the amendment is adopted or effective (whichever is later) or the last day of the plan year in which the amendment is adopted or effective (whichever is later), that is, the later of December 31, 2013, or March 15, 2014, (assuming no extensions are secured). The RAP is extended to the end of the 5-year RAP cycle which includes the date of the end of the RAP under § 1.401(b)–1. Therefore, Employer A would be required to adopt an amendment which corrected the disqualifying provision by January 31, 2018, but the amendment would be retroactively effective to the beginning of the RAP (that is, January 1, 2013).

.03 The remedial amendment period for a disqualifying provision described in § 1.401(b)–1(b)(3) is extended to the end of the plan's first five-year remedial amendment cycle ending at least twelve months after the applicable change in the qualification requirements of the Code is first listed in the Service's Cumulative List of Changes in Plan Qualification Requirements. See section 10 for more information regarding this list.

.04 Except as otherwise required, the time by which a plan must be amended for guidance changes relating to the plan qualification requirements is extended to the end of the plan's first five-year remedial amendment cycle ending at least twelve months after the applicable change in guidance is first listed in the Service's Cumulative List of Changes in Plan Qualification Requirements.

Example 3: The remedial amendment cycle for Plan Y is based on the last digit of Employer B's TIN, which is 4. Plan Y's cycle is Cycle D. The EGTRRA RAP for Plan Y ends January 31, 2010, and the subsequent 5-year RAP cycle ends January 31, 2015. In December 2009, guidance is published requiring plans to be amended and effective for the plan year beginning in 2010. The guidance will appear on the November 2010 Cumulative List. While Employer B updates Plan Y for the RAP that ends January 31, 2010, any remedial plan amendments that may be required because of the guidance effective in 2010 would not have to be adopted until Employer B updates Plan Y for the RAP that ends January 31, 2015. Employer B would then adopt plan provisions reflecting guidance effective in 2010 retroactive to the first day of the 2010 plan year.

SECTION 9. EXTENSION OF THE EGTRRA REMEDIAL AMENDMENT PERIOD/SCHEDULE OF NEXT FIVE-YEAR REMEDIAL AMENDMENT CYCLE

.01 The EGTRRA remedial amendment period is extended as provided in the following chart. The chart also provides the end dates of the first five-year remedial amendment cycle after EGTRRA.

If the TIN of the employer ends in —	The plan's cycle is —	The last day of the EGTRRA remedial amendment period (*i.e.*, the first cycle) is —	The next five-year remedial amendment cycle ends on —
1 or 6	Cycle A	January 31, 2007	January 31, 2012
2 or 7	Cycle B	January 31, 2008	January 31, 2013
3 or 8	Cycle C	January 31, 2009	January 31, 2014
4 or 9	Cycle D	January 31, 2010	January 31, 2015
5 or 0	Cycle E	January 31, 2011	January 31, 2016

.02 This extension of the EGTRRA remedial amendment period extends the remedial amendment period for all disqualifying provisions to which the EGTRRA remedial amendment period applies, including plan provisions required or permitted to be amended for EGTRRA, final regulations under § 401(a)(9) of the Code, Rev. Rul. 2001–62, Rev. Rul. 2002–27, and disqualifying provisions described in Rev. Proc. 2004–25.

.03 In accordance with section 8, the end of a plan's EGTRRA remedial amendment cycle is the time by which plan amendments must be adopted for other legislative changes and other guidance changes that have first been listed in the Cumulative List of Changes in Plan Qualification Requirements at least twelve months before the end of the plan's EGTRRA remedial amendment period.

.04 This extension does not waive any requirement for adoption of timely good faith EGTRRA plan amendments or other plan amendments that are required to be adopted as a condition of eligibility for the EGTRRA remedial amendment period.

SECTION 10. CUMULATIVE LIST OF CHANGES IN PLAN QUALIFICATION REQUIREMENTS

.01 The Service will publish a Cumulative List of Changes in Plan Qualification Requirements annually. The target date for publication of the list is mid-November of each year. The first list will be issued in conjunction with the opening of the EGTRRA opinion and advisory letter program for pre-approved plans.

.02 The annual Cumulative List of Changes in Plan Qualification Requirements will identify those changes in the qualification requirements of the Code as well as those items of published guidance relating to the plan qualification requirements, such as regulations and revenue rulings, that will be considered by the Service in its review of plans whose remedial amendment cycle ends on January 31 of the second calendar year following publication of the list. In other words, it is expected that determination letter applications for these plans will be submitted between February 1 of the calendar year following the publication of the annual list and January 31 of the next year, and the Service will review these plans taking into account the changes and guidance identified on the annual list. For example, it is expected that Cycle A plans will be submitted for determination letters between February 1, 2006, and January 31, 2007. The Service will review these plans on the basis of the Cumulative List of Changes in Plan Qualification Requirements that is published in the latter part of 2005.

.03 If an application for a determination letter is submitted prior to the February 1 that begins the last twelve months of the plan's remedial amendment cycle — that is, the application is filed early, or "off-cycle" — the application will be reviewed on the basis of the annual list which the Service is then using to review applications that have been filed "on-cycle." This means that the determination letter issued for the plan may not take into account any or all of the changes in qualification requirements for which the plan must be amended within the plan's current remedial amendment cycle. Consequently, the plan may need to be further amended within the cycle and another determination letter application will need to be filed within the last twelve months of the cycle if the plan sponsor wishes to preserve reliance on a determination letter. Also, the application will not be reviewed until all on-cycle plans have been reviewed and processed.

Example 4: The remedial amendment cycle for Plan Z is based on the last digit of Employer C's TIN, which is 0. Plan Z's cycle is Cycle E. The EGTRRA

RAP for Plan Z ends January 31, 2011, and the subsequent 5-year RAP cycle ends January 31, 2016. Employer C submits a determination letter application on March 1, 2009. The RAP cycle will expire on January 31, 2011. Therefore, Employer C may need to re-submit a new determination letter application during the last twelve months of the RAP cycle (between February 1, 2010, to January 31, 2011) to continue to have reliance on a determination letter after that date.

.04 The Service will not consider in its review of any determination letter application any change in the qualification requirements or published guidance that has not been identified in the applicable Cumulative List of Changes in Plan Qualification Requirements and a determination letter may not be relied on with respect to such changes or guidance.

.05 The Service may require the adoption of good faith plan amendments, as identified in the applicable Cumulative List, prior to the end of a plan's remedial amendment cycle. The Service will not consider these amendments in issuing a determination letter, and the letter may not be relied on with respect to the amendments, if the amendments relate to changes in the qualification requirements or guidance that has not been identified on the applicable Cumulative List of Changes in Plan Qualification Requirements.

SECTION 11. DETERMINATION LETTERS

.01 In general, plan sponsors of individually designed plans that wish to preserve reliance on a plan's favorable determination letter should apply for a new determination letter during the last twelve months of their plan's remedial amendment cycle, that is between February 1 and January 31 of the last year of the cycle.

.02 Determination letters issued for individually designed plans will take into account, and may be relied on with respect to, those changes in the plan qualification requirements and guidance identified on the applicable Cumulative List of Changes in Plan Qualification Requirements, as described in section 10.

.03 Determination letters issued for individually designed plans will include a statement that the letter may not be relied on after the end of the plan's first five-year remedial amendment cycle that ends more than twelve months after the application was received, and will include the specific "expiration date." Thus, determination letters issued for applications filed more than twelve months prior to the end of a five-year remedial amendment cycle may not be relied on after that cycle.

.04 In appropriate circumstances, the Service may, through generally applicable published guidance, extend the expiration dates of determination letters for a particular cycle year or years.

SECTION 12. TERMINATING PLANS

The termination of a plan ends the remedial amendment cycle for the plan. Accordingly, any retroactive remedial plan amendments or other required plan amendments for a terminating plan must be adopted in connection with the plan termination. An application will be deemed to be filed in connection with plan termination if it is filed no later than, the later of (i) one year from the effective date of the termination, or (ii) one year from the date on which the action terminating the plan is adopted; however, in no event can the application be filed later than twelve months from the date of distribution of substantially all plan assets.

SECTION 13. OPENING OF EGTRRA DETERMINATION LETTER PROGRAM FOR INDIVIDUALLY DESIGNED PLANS

Applications for determination letters for individually designed plans that are filed on or after February 1, 2006, will be reviewed taking into account the requirements of EGTRRA as well as other changes in qualification requirements and guidance identified on the applicable Cumulative List of Changes in Plan Qualification Requirements.

PART II — PRE-APPROVED PLANS

SECTION 14. SIX-YEAR AMENDMENT/APPROVAL CYCLE FOR M&P AND VOLUME SUBMITTER PLANS

.01 In general, sponsors of M&P plans and volume submitter plans must apply for new opinion or advisory letters for the plans every six years, according to the following schedule:

(1) Defined contribution plans	
Initial EGTRRA application due —	Next application due —
Sponsors: February 1, 2005, through January 31, 2006	February 1, 2011, through January 31, 2012
Mass Submitters: February 1, 2005, through October 31, 2005	February 1, 2011, through October 31, 2011

(2) Defined benefit plans	
Initial EGTRRA application due —	Next application due —
Sponsors: February 1, 2007, through January 31, 2008	February 1, 2013, through January 31, 2014
Mass Submitters: February 1, 2007, through October 31, 2007	February 1, 2013, through October 31, 2013

.02 An opinion or advisory letter that is issued for a pre-approved plan that is timely submitted in accordance with the preceding schedule will take into account and may be relied on with respect to the changes in qualification requirements and guidance changes listed in the Cumulative List of Changes in Plan Qualification Requirements that is published in the year before the year the filing of applications is accepted for the cycle.

.03 When the review of a cycle for a pre-approved plan has neared completion (after approximately a two-year review process), the Service will publish an announcement providing the date by which adopting employers must adopt the newly approved plans. This will be a uniform date that will apply to all adopting employers. It is expected that this date will give virtually all sponsors a two-year window for employers to adopt their updated plan. For purposes of this revenue procedure, an adopting employer means an employer who satisfies the requirements described under section 15.

.04 An adopting employer that adopts the approved M&P or volume submitter plan by the announced deadline will have adopted the plan within the employer's six-year remedial amendment cycle. The announced deadline will be the end of the plan's remedial amendment cycle with respect to all disqualifying provisions for which the remedial amendment period would otherwise end during the cycle.

.05 The Service may revise the schedule described in this section as needed to respond to changing circumstances and needs of plan sponsors.

SECTION 15. ELIGIBILITY FOR SIX-YEAR AMENDMENT/APPROVAL CYCLE

.01 An employer's plan is treated as a pre-approved plan and therefore will be eligible for the six-year amendment/approval cycle if the following requirements are satisfied:

(1) Before the end of the employer's five-year remedial amendment cycle as determined under Part I of this revenue procedure, the employer adopts a sponsor's or practitioner's approved (or interim) M&P plan or volume submitter specimen plan, or

(2) Before the end of the employer's five-year remedial amendment cycle as determined under Part I of this revenue procedure, the employer and an M&P plan sponsor or volume submitter practitioner execute Form **XXXX**, Certification of Intent to Adopt Pre-approved Plan, and

(3) By the application deadline of January 31st of the calendar year following the calendar year opening of the six-year remedial amendment cycle, the sponsor or practitioner submits an application for an opinion or advisory letter for the M&P plan or volume submitter specimen plan [as specified above] (even if the M&P plan or VS plan is an identical adoption of a mass submitter plan).

.02 If the preceding requirements found in section 15.01 are satisfied, the remedial amendment period for the plan will not expire before the end of the time period for adopting a pre-approved plan. By the end of the two-year adoption period as set forth by the Service, the employer must amend or restate its plan by adopting any pre-approved plan or individually designed plan, and if required for reliance, request a determination letter.

.03 If an employer who properly certified, prior to the end of its remedial amendment cycle, its intent to adopt a pre-approved plan but failed to adopt any pre-approved plan or individually designed plan that has been updated for all laws up to and including the applicable Cumulative List within the two-year deadline set forth by the Service and is unable to utilize its five-year remedial amendment cycle, then the adopting employer may be eligible for Employee Plans Compliance Resolution System (EPCRS).

.04 Change in Plan Status:

(1) If the status of a plan has changed due to the adoption of a different plan, the adoption and restatement of a plan, the adoption of a plan amendment or certification of intent to adopt a pre-approved plan, then the remedial amendment cycle will generally be based upon the plan's status after the change except where substantial changes were found to be made to a volume submitter plan; the six-year remedial amendment cycle will be used for application filing purposes.

(2) Except as stated in section 15.02, an employer who adopts an individually designed plan but who previously adopted a pre-approved plan will have a remedial amendment cycle for such plan which is determined under Part I of this revenue procedure.

Example 5: Employer X whose TIN ends with an 8 maintains Plan M. Plan M is a defined contribution plan and is an adoption of a pre-approved plan as of 2002. Assuming the pre-approved plan is timely submitted for EGTRRA update by the sponsor/practitioner on or before January 31, 2006, Employer X will have until January 31, 2010, to adopt the EGTRRA approved version of the pre-approved plan and have such adoption be considered timely under section 401(b) of the Code.

In 2007, Employer X decides the pre-approved plan it is using for purposes of Plan M no longer offers the flexibility it desires to provide the retirement benefits it wishes to its employees. As a result, Employer X restates Plan M in 2007 into an individually designed plan document. The result of this change in plan status in 2007 is that the EGTRRA remedial amendment period for the plan is no longer January 31, 2010, but is now January 31, 2009.

(3) An employer that amends any provision of an approved M&P plan including its adoption agreement (other than to change the choice of options, if the plan permits or contemplates such a change) is considered to have adopted an individually designed plan. The remedial amendment cycle in which the employer impermissi-

bly amends the M&P plan will remain the six-year remedial amendment cycle. However, the subsequent remedial amendment period is the five-year remedial amendment cycle as determined under Part I of this revenue procedure.

Example 6: Employer Y whose TIN ends with an 8 maintains Plan N. Plan N is a defined contribution plan and is an adoption of an M&P plan as of 2002. Assume the M&P plan is timely submitted for EGTRRA update by the sponsor/practitioner on or before January 31, 2006, and receives an opinion letter for such update dated January 31, 2008. This gives Employer Y until January 31, 2010, to adopt the EGTRRA approved version of the M&P plan and have such adoption be considered timely under section 401(b) of the Code.

On November 15, 2009, as part of adopting the EGTRRA approved version of the M&P plan Employer Y adopts an amendment to the approved M&P plan which alters or modifies the pre-approved provisions of the M&P plan. Thus, Employer Y's adoption of the M&P plan is no longer word-for-word identical. The result of this modification by Employer Y is that Plan N is now considered to be an adoption of an individually designed plan. When Employer Y submits Plan N for a determination letter by January 31, 2010, using Form 5300, *Application for Determination for Employee Benefit Plan*, the favorable determination letter will be stamped with an expiration date determined in accordance with Part I. In other words, Plan N's next remedial amendment cycle will be that of an individually designed plan and will expire on January 31, 2014.

(4) An employer that makes a substantial change to an approved volume submitter plan is considered to have adopted an individually designed plan solely for application filing purposes. The Service reserves the right to determine when the deviations from the language of the approved specimen plan is a substantial change and therefore requires an adopting employer to file a Form 5300. The remedial amendment cycle in which the substantial change was made and subsequent remedial amendment cycles will remain the six-year remedial amendment cycle.

Example 7: Employer Z whose TIN ends with an 8 maintains Plan O. Plan O is a defined contribution plan and is an adoption of a volume submitter plan as of 2002. The volume submitter specimen plan is timely submitted for EGTRRA update by the sponsor/practitioner on or before January 31, 2006, and receives an advisory letter for such update dated January 31, 2008. Employer Z has until January 31, 2010, to adopt the EGTRRA approved version of the volume submitter plan and to have such adoption be considered timely under IRC section 401(b).

On November 15, 2009, as part of adopting the EGTRRA approved version of the volume submitter plan, Employer Z alters or modifies the pre-approved provisions of the volume submitter plan. Thus, Employer Z's adoption of the volume submitter plan is not word-for-word identical to the approved volume submitter specimen plan. When Employer Z submits Plan O for a determination letter by January 31, 2010, using Form 5307, *Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans*, the Service specialist working the determination letter application determines the modification is not compatible with the purpose of the volume submitter program and requires Employer Z to re-file its determination letter application using Form 5300, *Application for Determination for Employee Benefit Plan*, and pay the higher user fee. Although the Service specialist working Plan O's determination letter application has required it to be filed on the form applicable to that of an individually designed plan, Plan O's next remedial amendment cycle will continue to be determined under this Part II.

SECTION 16. EFFECT ON OTHER DOCUMENTS

Reserved.

SECTION 17. EFFECTIVE DATE

Reserved.

SECTION 18. PAPERWORK REDUCTION ACT

Reserved.

DRAFTING INFORMATION

Reserved.

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

Announcement 2004–74

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.

On September 9, 2004, 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."

III. Notice of Suspension and Non-deductibility of Contributions

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

Al Haramain Islamic Foundation, Inc.
Ashland, Oregon
Effective Date: September 9, 2004

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.

Interest-Only REMIC Regular Interests

Announcement 2004–75

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document describes and explains rules that the IRS and Treasury are considering and may propose in a notice of proposed rulemaking (REG–106679–04) regarding the proper timing of income or deduction attributable to an interest-only regular interest in a Real Estate Mortgage Investment Conduit (REMIC). This document also invites comments from the public regarding these rules and other alternative rules. All materials submitted will be available for public inspection and copying.

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

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–106679–04), 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–106679–04), 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* (indicate IRS and REG–106679–04).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, Treena Garrett (202) 622–7180; concerning the proposals, Dale S. Collinson (202) 622–3900 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

BACKGROUND

The Tax Reform Act of 1986 (100 Stat. 2085) (1986–3 C.B. Vol. 1), created a new tax entity, the Real Estate Mortgage Investment Conduit (REMIC), that was designed to be the exclusive vehicle for the issuance of multi-class mortgage-backed securities. A REMIC may issue one or more classes of regular interests and must issue a single class of residual interest. Section 860B(a) of the Internal Revenue Code (Code) requires that a regular interest be treated as a debt instrument whether or not the interest would qualify as a debt instrument under general tax principles. The holders of the residual interest are required to take into account their proportionate share of the REMIC's taxable income or net loss.

Prior to 1988, the holder of a REMIC regular interest was required to be entitled to a specified principal amount plus interest at a fixed or variable rate. The Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342) (1988 C.B. 1) permits the holder of a REMIC regular interest to receive interest that consists of a specified portion of the interest payments on qualified mortgages if the portion does not vary during the period the regular interest is outstanding. Section 860G(a)(1)(B)(ii). The expanded definition of REMIC regular interest has allowed for the issuance of interest-only REMIC regular interests (REMIC IOs).

A REMIC IO generally provides for a nominal (or zero) specified principal amount and stated interest consisting of a specified portion of the interest payments on mortgages held by the REMIC.[1] Section 860B(a) provides that a REMIC regular interest is taxed as a debt instrument. Nevertheless, a REMIC IO differs from a traditional debt instrument in that the aggregate of the amounts received by the holder of a REMIC IO may be less than

[1] The terms of a REMIC may provide that the specified principal amount of a REMIC IO is zero. Although section 860G(a)(1)(A) requires a regular interest "unconditionally [to] entitle[] the holder to receive a specified principal amount (or other similar amount)," §1.860G–1(a)(2)(iv) states, "If an interest in a REMIC consists of a specified portion of the interest payments on the REMIC's qualified mortgages, no minimum specified principal amount need be assigned to that interest."

the amount for which the instrument was issued. This may occur if the underlying mortgages are prepaid at an unexpectedly rapid rate. In that case, the amounts of interest paid on these mortgages will be less than expected, and the amounts payable to the holder of the REMIC IO will be correspondingly reduced. As a result, REMIC IOs present novel and difficult questions in the application of tax rules that were designed primarily to account for instruments that qualify as debt under traditional tax principles.

Section 1275(d) authorizes regulations to modify the tax treatment prescribed by sections 163(e) and 1271 through 1275 (relating to original issue discount (OID)) if the statutory tax treatment does not carry out the purposes of those sections. The IRS and Treasury are considering whether to issue regulations, including regulations under the authority of section 1275(d), with respect to the tax treatment of REMIC IOs for issuers and initial- and secondary-market purchasers. This advance notice of proposed rulemaking sets out additional background information, including summary descriptions of possible approaches to the problems described below, and requests public comment.

CURRENT TAX TREATMENT OF REMIC IOs

As noted, the terms of a REMIC IO generally provide both for stated interest consisting of a specified portion of the interest payments on mortgages held by the REMIC and also may provide for a nominal amount of specified principal. The tax rules currently applicable to a REMIC IO depend on whether the stated interest is treated as consisting entirely of interest or as being, in part, a return of the proceeds for which the instrument was issued.

Some taxpayers believe that, if the stated interest is respected as interest, it generally is qualified stated interest (QSI) and so is not part of the stated redemption price at maturity (SRPM). As a result, because the specified principal due on the REMIC IO is, at most, nominal, a holder generally will have paid more than the amount payable when the REMIC IO matures, and thus there will be bond premium. On the other hand, if the interest payments are recast as, in part, a return of the proceeds for which the REMIC IO was issued, the portions so recast are included in the SRPM, and the instrument is issued with OID.

Glick v. United States, 96 F. Supp. 2d 850 (S.D. Ind. 2000), weighed these competing analyses of a REMIC IO. The instrument at issue in the case had been issued for a little over $12 million. The terms of the instrument provided both for specified principal of $362,000, which was based on principal payments on the underlying mortgages, and for much larger expected amounts of stated interest, which were linked to, and contingent upon, interest payments on the underlying mortgages.

Given the terms of the mortgages and the rate at which the mortgagors were, in the aggregate, expected to prepay their mortgages, the prospectus estimated total future cash flows under the REMIC IO of over $14 million. Basing its computation on the specified principal amount, the prospectus identified the resulting estimated interest rate on the REMIC IO as being 1006.7 percent. On the other hand, the prospectus further disclosed that, if a yield computation were to be based on the taxpayer's purchase price of over $12 million, the anticipated yield to maturity was just under 8 percent.

Because of falling interest rates, the mortgages underlying the instrument were prepaid at an extremely fast rate, and the taxpayer recovered less than two thirds of the original investment.

The Government argued that the instrument was issued at a discount and that the taxpayer's loss on the instrument was capital and would be recognized only in the year the instrument was retired. The taxpayer, on the other hand, claimed that the instrument was acquired at a premium and that ordinary deductions were allowable under section 171 during the entire period that the taxpayer held the instrument. Explaining that it had resolved the question by "[e]xamining the economic reality of the transaction," 96 F. Supp. 2d at 867, the court issued summary judgment for the Government.

Original Issue Discount

REMIC regular interests are among the debt instruments for which the accrual of OID is calculated taking prepayments into account. This is accomplished by using a method commonly known as the prepayment assumption catch-up (PAC) method, which is provided in section 1272(a)(6). Under this method, it is necessary to estimate first the rate at which any outstanding principal on the underlying mortgages will be prepaid and, then, the yield to maturity of the instrument. These estimates remain constant in all PAC method computations throughout the life of the instrument.

In each accrual period, the daily accruals of OID are equal to the ratable portion of the *excess* (if any) of the sum of (1) the present value of the remaining payments under the debt instrument as of the close of the period (end-of-period present value) and (2) the payments during the accrual period that are included in the SRPM (accrual-period SRPM receipts), *over* the adjusted issue price of the debt instrument at the beginning of the period.[2]

The end-of-period present value is calculated using the two estimates referred to above. First, the amount and time of the remaining payments are determined on the basis of both the specified principal actually outstanding at the end of the accrual period (taking into account any prepayments occurring before the close of the accrual period) and the previously estimated, static assumption about the rate at which any outstanding principal will be prepaid. Second, the present value of these remaining payments is determined by discounting them at the previously estimated original yield to maturity.

A holder of an OID debt instrument includes in gross income the sum of the daily portions of the OID for each day during the taxable year on which it holds the debt instrument. An issuer's interest deduction for OID accruals is computed in a similar fashion.

In the case of a traditional debt instrument that is issued with OID or a REMIC regular interest that is issued for less than its specified principal amount, prepayments increase the instrument's yield to maturity. Failure to anticipate prepayments would result in uneconomic

[2] For each period, interest income or expense with respect to the REMIC regular interest also includes accruals of QSI.

deferred accrual of OID inclusions, and the holder would recognize capital gains when the instrument is finally sold or retired. To prevent such uneconomic deferral of OID inclusions, the PAC method, in each period, recognizes more OID than would be recognized if no anticipated prepayments were taken into account. However, the PAC method may result in uneconomic acceleration of OID accruals in certain circumstances.

When section 1272(a)(6) became law, an instrument subject to it generally provided for payments of a fixed amount of specified principal, plus payments of QSI, which were based on the amount of principal still outstanding. If the issue price of the instrument was less than the specified principal, that difference resulted in a fixed amount of OID, which had to be accrued over the life of the instrument.

For such an instrument, if actual prepayments occur at a slower rate than the original estimate, OID will be accrued more rapidly under the PAC method than the actual prepayment rate would justify. If prepayments are particularly slow, the OID remaining to be received at the end of a period may be greater than the excess of the original OID on the instrument over the amount of the OID that had been accrued in prior periods. As a result, the amount of OID for the current accrual period under the formula in the PAC method may be a negative number (Negative OID).[3] This occurs if the adjusted issue price at the beginning of an accrual period (which reflects prior OID accruals) exceeds the sum of (1) the end-of-period present value and (2) the accrual-period SRPM receipts.

Because the amount of OID to be received over the life of the instrument is fixed, and thus the OID that had been previously accrued will be received eventually, the premature accruals may be addressed by a period of nonaccrual of OID. An alternative approach would be to reverse the premature accruals by recognizing Negative OID in the current period and then to accrue the OID again later.

In enacting the PAC formula, Congress expressed its intent that the rules implementing the PAC method would use a period of nonaccrual to correct possible premature accruals and would not accrue and recognize Negative OID.

> The conferees intend that in no circumstances, would the method of accruing OID prescribed by the conference agreement allow for negative amounts of OID to be attributed to any accrual period. If the use of the present value computations prescribed by the conference agreement produce[s] such a result for an accrual period, the conferees intend that the amount of OID attributable to such accrual period would be treated as zero, and the computation of OID for the following accrual period would be made as if such following accrual period and the preceding accrual period were a single accrual period.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–239, 1986–3 (Vol. 4) C.B. 239. The IRS and Treasury understand that taxpayers generally comply with this intent not only for ordinary REMIC regular interests but also for REMIC IOs.

The quoted expression of Congressional intent occurred before the 1988 amendment permitting REMIC IOs. In the case of a REMIC regular interest that resembles a traditional debt instrument (such as the regular interests that existed before the 1988 amendment), a Negative OID computation is evidence that unexpectedly *slow* prepayments may have caused OID to accrue more rapidly than, in hindsight, it should have. In such a situation, disallowing Negative OID causes a timing issue. To the extent that OID has been overaccrued, the accrual period is extended until the computation for the extended accrual period produces a positive result. This future positive result of the computation has to occur eventually as principal on the debt instrument is repaid.

By contrast, in the case of a REMIC IO, a Negative OID computation may occur because unexpectedly *rapid* prepayments reduce the amount of OID that will ever be received or paid under the terms of the instrument. Rather than the right amount of OID being accrued too fast, the wrong amount has been accrued. In the case of a REMIC IO, therefore, the prohibition against Negative OID may result in denying the holder current recognition of an overall actual loss that will not be reversed in future periods and may only be realized upon the sale or maturity of the REMIC IO.

There is also a corresponding distortion to the net income or net loss of the REMIC (and thus to the income or net loss of the holder of the residual interest). Even if one or more holders of the REMIC IOs sell their interests and recognize losses that correct their own overaccrual of OID income, nothing corrects the REMIC's overaccrual of OID deductions until the instrument is finally retired. This asymmetry may result in an understatement of the overall tax base attributable to income from mortgages held in REMICs (the total amount taxable to holders of REMIC regular interests and REMIC residual interests).

Market Discount

Section 1276(b)(3) provides that the accrual of market discount on a debt instrument the principal of which may be paid in installments shall be determined under regulations. Regulations have not yet been issued.

The legislative history of the Tax Reform Act of 1986, however, states that, until regulations are issued, if a debt instrument is issued with OID and the principal of the instrument may be paid in two or more installments, then holders of the instrument may elect to accrue market discount for the instrument either on a constant yield basis or in proportion to the OID accruals on the instrument. Under the latter method, the amount of market discount that accrues during an accrual period is determined by multiplying the total remaining amount of market discount on the instrument as of the beginning of the period by a fraction the numerator of which is the amount of OID for the period and the denominator of which is the total remaining OID at the beginning of the period.[4] See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–842 (1986), 1986–3 (Vol. 4) C.B. 842. The IRS and Treasury understand that, under current practice, during any period for which the PAC method produces Negative OID, the numerator of the

[3] In 1986, Congress expressed its intent that Negative OID would not be currently recognized. For that reason, the term is used here to refer to a negative result for the computation required by the formula in the PAC method, not to an amount that is necessarily recognized for tax purposes.

[4] If an instrument that provides for two or more principal payments is issued without OID, Congress intended for market discount to be accrued according to the same rule, but with stated interest playing the role of OID. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–842 (1986), 1986–3 (Vol. 4) C.B. 842.

fraction is treated as zero, and no market discount is accrued. In some cases, this practice may uneconomically defer recognition of market discount.

If the rules in section 1272(a)(6) apply to a debt instrument (without regard to whether the instrument is issued with OID), this legislative history indicates that accruals of market discount on the instrument are to be determined using the same prepayment assumption as that used under section 1272(a)(6) (whether or not the taxpayer elects under section 1276(b)(2) to accrue market discount on a constant-yield basis). See *id*.

The IRS and Treasury are aware of several possible methods, discussed below, for addressing the foregoing problems.

INSTRUMENTS TO WHICH NEW RULES MIGHT APPLY

Because of the range of instruments to which section 1272(a)(6) applies and the breadth of the new accounting methods about which comment is being requested, any new method might not necessarily be limited to REMIC IOs. For example, a new method might apply to interest-only strips from fixed investment mortgage trusts. In addition, a new method might apply to all instruments that provide for disproportionately high interest payments (as defined in §1.860G–1(b)(5)). Under this approach, the new rules would apply to REMIC regular interests whose issue price exceeds 125% of the specified principal amount and to similar non-REMIC interests.

PROPOSALS BASED ON EXISTING RULES FOR DEBT

PAC Method Without Prohibition On Recognizing Negative OID

Although the PAC method may sometimes fail to clearly reflect the income of the holder or the issuer of a REMIC IO, the method is not without merit. The method is specifically designed to deal with debt instruments that are subject to prepayments, like traditional REMIC regular interests. Under the PAC method, if loans are actually prepaid faster than expected, the projected future cash flows are adjusted immediately to more accurately reflect income. To a large extent, the problems arising from the application of the PAC method to REMIC IOs arise from the prohibition against taking Negative OID into account.

Because REMIC IOs did not exist when the 1986 legislative history discussing Negative OID was drafted, that discussion related to a Negative OID computation that would indicate that the affected taxpayers had accrued some OID too soon, rather than that they had accrued OID that would never be paid or received. Congress might have articulated a different intent concerning Negative OID if it had addressed the issue once REMIC IOs were permitted.

Accordingly, the IRS and Treasury are considering whether to propose a regulation that would follow the section 1272(a)(6) formula in the current PAC method, except that the regulation would specifically allow holders of regular interests to accrue Negative OID deductions and would require the REMIC (and thus the holder of the REMIC residual interest) to accrue and recognize income from Negative OID.

The considerations supporting recognition of Negative OID by initial purchasers may not apply with equal force to secondary-market purchasers. Secondary market prices are likely to reflect both prepayment history and revised expectations regarding future prepayments, with the result that the Negative OID deduction that might be appropriate for an initial purchaser may exceed any actual economic loss sustained by a particular secondary-market purchaser. The secondary-market purchaser's depressed purchase price, however, is likely to result in a substantial amount of market discount. See section 1278(a)(2). The rules for accruing Negative OID and market discount will have to be coordinated to produce a net result that is economically sensible.

Accordingly, it may be appropriate either to develop explicit rules to effect this coordination or to limit recognition of Negative OID in the case of secondary-market purchasers. For example, recognition of accrued Negative OID might be limited to the aggregate of amounts that the secondary-market holder previously included in income as accrued OID or accrued market discount. However, in the case of a secondary-market holder who has suffered a real economic loss on a REMIC IO, such a limitation could uneconomically defer recognition of that loss.

Moreover, if a limitation on the allowance of Negative OID is applied to secondary-market purchasers, perhaps a similar limitation for initial purchasers will be needed to avoid disparate treatment of similarly situated holders (for example, initial purchasers and secondary-market purchasers that purchase shortly after original issuance at a price substantially the same as the issue price). However, such a limitation would also perpetuate many of the problems previously described.

Any rule recognizing Negative OID would have to deal with a variety of collateral consequences, such as adjustments to the instrument's adjusted issue price and the holder's basis in the instrument to reflect any deduction for Negative OID. Comments are requested concerning both the range of collateral consequences of recognizing Negative OID and the ways in which these consequences should be dealt with.

Allowing Section 166 Bad Debt Deduction

Another way to more clearly reflect the income of holders of REMIC IOs would be to issue regulations under section 166 (which concerns deductions for bad debts). These rules might both determine when (prior to realization) a holder has sustained an economic loss and also allow a deduction for the loss under section 166.[5] Section 166(a) provides a deduction for any debt that becomes wholly or partially worthless during the taxable year. Indeed, some holders of REMIC IOs have claimed deductions for partial worthlessness under section 166(a)(2) and §1.166–3. The rules for determining worthlessness and partial worthlessness, however, were developed with reference to debts that become worthless or partially worthless because of the issuer's anticipated failure ever to make required payments, not because certain contingencies (such as rapid prepayments) have reduced the amounts

[5] Section 165(g) allows a deduction for losses on worthless "securities," as defined in section 165(g)(2)(C). REMIC regular interests, however, fall outside this definition, because they are not issued by a government, a political subdivision, or a corporation. (Under section 860A(a), a REMIC is not treated as a corporation.)

required to be paid. Thus the existing regulations under section 166 focus on whether a debt instrument is uncollectible and cannot be fully satisfied through foreclosure on collateral. See, for example, §§1.166–2 and 1.166–6. By contrast, the existence of Negative OID for a REMIC IO is evidence that the amounts contractually owed under the terms of the instrument are being reduced, not that the holder cannot collect whatever amounts are so owed.

Comments are invited regarding (1) whether, in the absence of any default by the issuer, the policy underlying the allowance of a deduction for worthlessness and partial worthlessness should be extended to a change in the amount that the issuer is required to pay, and (2) whether any rule allowing a deduction under section 166 can be extended to, or combined with, rules respecting corresponding income inclusions for REMICs and the timing of the inclusions.

ALTERNATIVE PROPOSAL SPECIFIC TO REMIC IOS AND SIMILAR INSTRUMENTS

The foregoing discussion attempts to provide a method for recognizing interest income and deduction from a REMIC IO by altering an existing method applicable to traditional debt instruments. Although it may be possible to alter an existing method, doing so is difficult because existing methods are designed to apply to debt and a REMIC IO is unlike most debt. Furthermore, as previously indicated, altering an existing method often leads to collateral problems that must be addressed. Therefore, an alternative method created especially for REMIC IOs, and similar instruments, may better reflect the income and deductions for these instruments.

Economically a holder of a REMIC IO (like other investors) has invested cash in an instrument and expects to receive cash flows from that investment. What is distinctive about a REMIC IO is that the amount and duration of the cash flows are unknown at the time of making the investment. Given the economics of the REMIC IO, a method for distinguishing between receipt of income and recovery of the amount originally invested could be based on the projected (but uncertain) cash flows under the instrument and not on the expectation of a fixed return. The following method attempts to achieve that objective.

First, the holder of a REMIC IO would include payments made on the REMIC IO in income as they are received. The holder would then be allowed an offset to any payments included in income for the period. The offset would be equal to an amount that bears the same ratio to the investment as the payments for the period bears to the total expected payments (based on a prepayment speed assumption). The total expected payments would be calculated each period taking into account both an updated prepayment-speed assumption and any payments made on the REMIC IO. For this purpose, the investment is the total investment cost (*i.e.*, the issue price).

Offset Formula: $$\text{Offset} = \text{Investment} \times \frac{\text{Payments for period}}{\text{Total expected payments}}$$

At the maturity of the IO, and perhaps at earlier times, a look-back regime may be appropriate to correct any under- or over-accrual of interest. See section 167(g)(2).

For an example of this method, see the appendix.

Comments are requested on two aspects of this IO-specific method in particular. First, can a variation of the method be applied to determine appropriate interest deductions for the REMIC? Second, in the typical REMIC IO, cash-flows start high and then decline to zero. For these instruments, the new method may clearly reflect income. One of the method's weaknesses, however, is that, unlike OID accrual generally, the method does not accrue OID prior to the receipt of the cash representing the OID. An issue exists as to what regime should apply if the application of existing regulations to tiered structures produces REMIC IOs the cash flows on which are not expected to begin until well after the issue date.

SECONDARY-MARKET PURCHASERS

Unlike initial purchasers, taxpayers who acquire REMIC regular interests subsequent to issue may have to take into account not merely accruals of OID but a combination of OID and market discount or a combination of OID and acquisition premium. As discussed above, the issues concerning OID accruals and the possible recognition of Negative OID require separate consideration with respect to secondary-market acquisitions.

The IRS and Treasury are considering alternative rules for the accrual of market discount attributable to REMIC IOs. One possible rule is to require accruals under a formula similar to the PAC method, including the use of a prepayment assumption and discount rate that remain static. However, instead of the projected prepayment speed and the projected yield to maturity being fixed as of the date on which the REMIC issues all of its regular interests, they would be fixed for a subsequently acquired REMIC IO at the time of the acquisition. Essentially a holder of a REMIC IO would apply the same methodology regardless of whether its acquisition was on the issue date (with the holder calculating OID based on estimates that were fixed on that date) or on a subsequent date (with the holder calculating market discount based on estimates that were fixed on the subsequent acquisition date).

If the amount of market discount is based on the revised issue price, as provided in section 1276(a)(2) and (4), the rules will need to integrate accrual of market discount (which will be specific to each holder) and accrual of OID (which will be the same for all holders). If the amount of market discount is based on remaining SRPM at the time of acquisition, accrual of the market discount will be a substitute for any OID accrual. In either case, a holder with any market discount will need substantial amounts of individualized data from the REMIC servicer. Comments are requested as to the REMIC servicer's ability to provide the necessary individualized data.

It would be possible to revise the rules for accrual of market discount without adopting a rule recognizing Negative OID. As described above, however, if this recognition is permitted generally and is made available to secondary-market purchasers as well as initial purchasers, additional questions will be presented for secondary-market purchasers. These would include whether the amount of market discount should be redetermined and, if so, what the effect of that determination would be on collateral consequences of market discount such as the deferral of interest deductions under section 1277. One possibility would be to condition the recognition of Negative OID for secondary-market purchasers on an election by the holder to be taxable under the OID rules on both OID and market discount or premium. (See the election under §1.1272–3.)

NEGATIVE YIELD INSTRUMENTS

The IRS and Treasury are aware that there are some REMIC IOs for which the prepayment speed that the servicer projected at the pricing date produces a projected negative yield. Arms-length investors do not voluntarily enter transactions with anticipated negative yields. Rather, such an investor may subjectively anticipate a different prepayment speed, or the investor may be "making a bet" on the occurrence of a prepayment scenario with a rate of return that more than compensates for its low probability of occurring. Mathematically, "discounting" a cash flow at a negative yield produces a present value that is greater than the sum of the future values of the cash flow. Unmodified application of the PAC method would therefore be unreasonable because it would require the holder to include amounts in income that are based on unrealistically high deemed present values of future cash flows. Comments are requested on whether the PAC method should be altered by requiring the use of a discount rate that is no less than an economically reasonable discount rate or whether some other adjustment would be more appropriate.

REQUEST FOR COMMENTS

The IRS and Treasury request comments on the desirability of adopting special rules for taxing REMIC IOs, high-yield REMIC regular interests, and apparent negative-yield instruments, and whether those special rules should also be applied to other similar instruments (including how to identify such similar instruments). Comments and suggestions are also requested regarding possible approaches to what additional special rules may be desirable, including the possible recognition of Negative OID, the formulation of special guidelines for the application of section 166 to REMIC IOs and similar instruments, and the adoption of a new alternative method applicable to REMIC IOs and similar instruments.

Persons providing comments may want to consider, among other things, the following questions. Should recognition of Negative OID be limited to prior inclusions of OID, to prior inclusions of OID and market discount, or to some other amount? If any limit is imposed, should the limit apply to all holders or only to those who do not acquire their interests at original issue? If recognition of Negative OID by initial purchasers is limited to prior OID inclusions, should recognition of Negative OID be permitted for secondary-market purchasers to the extent of prior market discount inclusions as well as OID inclusions? If recognition of Negative OID is unlimited for initial purchasers, should it be limited for secondary-market purchasers? Should recognition of Negative OID for secondary-market purchasers result in a redetermination of a purchaser's market discount and, if so, should the redetermination affect the application of the interest deferral provisions in section 1277? Alternatively, is the situation addressed adequately by currently recognizing both Negative OID and currently accruing market discount? Should recognition of Negative OID by secondary-market purchasers be conditioned on an election to treat all discount and premium on the instrument as OID?

Nancy Jardini,
Acting Deputy Commissioner for Services and Enforcement.

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APPENDIX

Examples

Issue Price $8.97 Expected Yield 8.455%

Expected Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	2.50
Year 3	1.50
Year 4	1.00
Year 5	0.50

If pays as expected:

End AIP	Payments	Beg. AIP	OID
4.73	5.00	8.97	.76
2.63	2.50	4.73	.40
1.35	1.50	2.63	.22
0.46	1.00	1.35	.11
0	0.50	0.46	.04
			1.53

Actual Yield 8.455%

If pays faster than expected:

End AIP	Payments	Beg. AIP	OID
1.89	5.00	8.97	(1.11)
1.05	1.00	2.86	(0.35)
0.54	0.60	1.50	(0.19)
0.18	0.40	0.72	(0.09)
0	0.20	0.23	(0.03)
			(1.77)

Actual Yield -12.397%

Holder's OID Income under Current Rules (w/Negative OID prohibition):

Year 1	0
Year 2	0
Year 3	0
Year 4	0
Year 5	0

1.77 loss at maturity

Holder's OID income under Proposal allowing Negative OID:

Year 1	(2.08)loss
Year 2	0.16
Year 3	0.09
Year 4	0.05
Year 5	0.02

Overall income (1.77)

ALTERNATIVE METHOD EXAMPLE

Examples:

Investment/Issue Price $8.97 Expected Yield 8.455%

Total expected return: $10.50

Example 1

Expected Cash Flows:	
Year 0	(8.97)
Year 1	5.00
Year 2	2.50
Year 3	1.50
Year 4	1.00
Year 5	0.50

(*Offset amounts in bold*.)

Year 1
payments for year/total expected payments = 5/10.5 = .47
ratio multiplied by investment = .47(8.97) = **4.27**

Year 2
2.5/10.5 = .23
.23(8.97) = **2.14**

Year 3
1.5/10.5 = .143
.143(8.97) = **1.28**

Year 4
1/10.5 = .095
.095(8.97) = **.85**

Year 5
.5/10.5 = .047
.047(8.97) = **.43**

[4.27 + 2.14 + 1.28 + .85 + .43 = 8.97]

Example 2

If the expected return is not updated, the holder won't recover its investment.

Actual Cash Flows:	
Year 0	(8.97)
Year 1	5.00
Year 2	1.00
Year 3	0.60
Year 4	0.40
Year 5	0.20

Year 1
5/10.5 = .48
.48(8.97) = **4.27**

Year 2
1/10.5 = .095
.095(8.97) = **.85**

Year 3
.6/10.5 = .06
.06(8.97) = **.51**

Year 4
.4/10.5 = .04
.04(8.97) = **.34**

Year 5
.2/10.5 = .02
.02(8.97) = **.17**

[4.27 + .85 + .51 + .34 + .17 = 6.14]

Example 3

If you update the expected return after year 1:

Actual Cash Flows:	
Year 0	(8.97)
Year 1	5.00
Year 2	1.00
Year 3	0.60
Year 4	0.40
Year 5	0.20

Year 1
5/10.5 = .48
.48(8.97) = **4.27**

After year 1, total expected return is 7.20 (5+1+.6+.4+.2):

Year 2
1/7.2 = .14
.14(8.97) = **1.25**

Year 3
.6/7.2 = .08
.08(8.97) = **.75**

Year 4
.4/7.2 = .06
.06(8.97) = **.50**

Year 5
.2/7.2 = .03
.03(8.97) = **.25**

[4.27 + 1.25 + .75 + .50 + .25 = 7.02]

If the holder recalculates Year 1, using the new total expected return ((5/7.2)(8.97)) = 6.23), and takes into account the difference between that amount (6.23) and the amount calculated using the original expected return (4.27), which equals 1.96, the holder will recover its total investment.

Foundations Status of Certain Organizations

Announcement 2004–76

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

38th & Shadeland Community Development Corporation, Indianapolis, IN
64th Illinois Company E YSS, Inc., Joliet, IL
A. Carlin Foundation, Incorporated, East Thetford, VT
Abra, Inc., Skokie, IL
Academy of Learning, Inc., Chicago, IL
Academy Video Clearinghouse, Inc., Riverdale, GA
Active Pursuit of Entrepreneurial Excellence, Inc., Chicago, IL
Advanced Wound Care Research Laboratories, Inc., Las Vegas, NV
Ahanta Association of USA, Inc., Burbank, CA
Aides Resource Committee for Knox County, Vincennes, IN
Allapattah Community Development and Betterment Corporation, Miami, FL

American Country, Inc., Lebanon, IN
American Friends of Musee D' Art Moderne Grand-Duc Jean Luxembourg, New York, NY
Appalachian Children's Museum and Learning Center, Inc., Pikeville, KY
Apple Development Association, Inc., Danville, IN
Art PTC, Inc., E. Amherst, NY
Aspen-Olive Community Development Corp., Philadelphia, PA
Association of College and University Auditors Foundation, Homewood, IL
At Bethlehems Door, La Grange, IL
Atherton Baptist Village, Alhambra, CA
Attention Deficit Disorder Center of Ann Arbor, Inc., Ann Arbor, MI
Backus Foundation, Inc., Norwich, CT
Band of South Bend, South Bend, IN
Bangla Literature & Culture, Inc., Plano, TX
Bascom Volunteer Fire Department, Bascom, FL
B.B. King Foundation of Indianola, Inc., Indianola, MS
Ben Davis Band Boosters, Inc., Indianapolis, IN
Beth Israel Ministries International, Stanton, MI
Biloxi Affordable Housing Partners, Biloxi, MS
Blues Before Sunrise, Forest Park, IL
Body Contouring Research Foundation, Wayzata, MN
Boulevard Preservation Society of Greater Illinois, Chicago, IL
Branches of Blackness, Inc., Bronx, NY
Bullpen Aces, Inc., Russiaville, IN
C-Ville Youth Athletics, Inc., Crothersville, IN
Calvin T. Lam Relief Organization for Orphanage Foundation, Hesperia, CA
Camerata Fine Arts, Inc., Valparaiso, IN
Canton Future, Canton, IL
Capital Child Care Academy, Inc., Springfield, IL
Cardiology Associates Foundation, New York, NY
Carl Sagan Foundation, Inc., Ithaca, NY
Carolina Upper Savannah Health Care Foundation, Inc., Greenwood, SC
Center for Investor Protection, Inc., Arlington Heights, IL
Central Atlanta Neighbors, Inc., Atlanta, GA
Central California Adolescent Development Corporation, Fresno, CA
Central City Community Neighborhood Development Corporation, Inc., Gloucester, MA
Charleston Christian Youth Association, Charleston, IL
Charlie Rose Foundation, Inc., Chappaqua, NY
Chestertown Arts League, Inc., Chestertown, MD
Chicago 2020, Chicago, IL
Chicago Management Council, Chicago, IL
Chicago River Rowing Foundation, Inc., Chicago, IL
Chicagoland, Chicago, IL
Chosen Generation Ministries, Springfield, IL
Christ Works Ministries, Inc., Mooresville, IN
Christian Businesses of Tippecanoe County, Inc., Lafayette, IN
Christs Church, Las Vegas, NV
Citizen Computing Institute, New York, NY
Civil War Landscapes Association, Chicago, IL
Clark County Genealogical Library, Marshall, IL
Clarks Child Development Center, Inc., Glenwood, IL
Cole Spencer Hilfiger Foundation, Virginia Beach, VA
Committee to Renovate Fawcett Stadium, Inc., Canton, OH
Community & Business Resource Development Corp., East Hazel, IL
Community Care Alliance, Inc., Indianapolis, IN
Community Hope, Inc., Fayetteville, NC
Community Ministers Alliance of Chicago, Chicago, IL
Community Partnership for Justice, Inc., Indianapolis, IN
Community Relief Foundation, Jackson, MS
Compassionate Vision, Inc., Batavia, IL
Computer Training Empowerment Consortium, Inc., Aurora, IL
Congress Parkway Council, Chicago, IL
Country Hope USA, Inc., Burbank, IL
Crandall Citizens Police Academy Alumni Association, Crandall, TX
Crisis Management Interveners, Inc., Dolton, IL
Criterion Foundation, Evergreen, CO
Crossroads Music Ministries, Inc., Marion, IL
Crusade to Protect Abused Children, Inc., Springfield, IL
CST Foundation, Chicago, IL
Cultural Conservation, Pinehurst, NC
Cupula, Chicago, IL
Debra Marie Lugar Memorial Foundation, Garden Ridge, TX
Diabetes Cares Foundation A Calif. Non-Profit Public Benefit Corp., Salinas, CA
Directors Theatre of Chicago, Chicago, IL
Doll House Theater of Norwalk Ohio, Mansfield, OH
Doris Loving Family Life Center, Austin, TX
Double R Scholarship Foundation, Inc., Goshen, IN
Dovetail Christian Ministries, Inc., Cazenovia, NY
Dr. H. B. Brady Foundation, Chicago, IL
Dream of Jeanie Foundation, Chicago, IL
Dream Street Corporation, Chicago, IL
Dreams Come True Organization, Chicago, IL
Drexel Boulevard Mansion Foundation, Chicago, IL
Dristi, Palatine, IL
Drone Foundation, Inc., Ann Arbor, MI
Duluth East Hockey Alumni Association, Inc., Duluth, MN
E & V Services, Ann Arbor, MI
Eagles Flight, Inc., Greenfield, IN
Earth Prayers Foundation, Cleveland Heights, OH
Earthcare International, Inglewood, CA
East Chicago Community Health Center, Inc., East Chicago, IN
Ed Boyle Community Fund, Cleveland, OH
Environmental Center of Dallas, Inc., Dallas, TX
Epilepsy Education Association, Inc., South Bend, IN
Equality Network, Anderson, IN
Esperanza Development, Inc., Niles, IL
ETC Foundation, Inc., Chicago, IL
Faith Temple Word of Faith Outreach, Jackson, MI
Faith Works Academy, Hurst, TX
Family Medical Physician Group, Inc., Colorado City, TX
Family Resource Center a Division of Lincoln Park Missionary Baptist Church, Jeffersonville, IN
Father Fred Furey Scholarship Fund for Marion St. Mary Grade School, Marion, OH
Fellowship Manor, Ltd., Chicago, IL

Fenton Family Foundation, Lathrup Village, MI
Festival Concerts, Inc., Salt Lake City, UT
Filipino American Senior Homes, Inc., Chicago, IL
Flashes Football Foundation, Indianapolis, IN
Floricente Organization, Moline, IL
Forgotten Childrens Foundation, Lake Zurich, IL
Foundation for Athletic Martial Arts Excellence, Yuma, AZ
Foundation for Scientific Literacy, La Jolla, CA
Fox River Grove Memorial Pavilion Foundation, Fox River Grove, IL
Frederick Douglass Company, Chicago, IL
Friend to Friend, Incorporated, Fort Wayne, IN
Friends & Helpers Foundation, Encino, CA
Friends of Central Pool, Inc., Noblesville, IN
Friends of the Cleveland Police Auxiliary, Cleveland, OH
G-Force Boosters, Inc. Prescott, AZ
Generations – Research Foundation for Domestic Violence, Rockwall, TX
Genesys 2000 Foundation, Maywood, IL
Gillespie Adult Foster Care, Inc., Bloomfield Hills, MI
Global Crossroads Foundation, Inc., Indianapolis, IN
God, Culture and Community Services, Inc., Plainfield, NJ
Golden Door Productions, Inc., Indianapolis, IN
Good Works Chicago, Chicago, IL
Grace Preservation Corporation, Chicago, IL
Gracious Living, Yreka, CA
Graysville Elementary School Parents and Teachers Organization, Graysville, IN
Greater Peoria Interfaith Hospitality Network, Peoria Heights, IL
Half Moon Bay Coastside Foundation, Half Moon Bay, CA
Hamilton Heights Residential Management, Ltd., New York, NY
Hampton Roads Childcare, Inc., Chesapeake, VA
Harbor House, Inc., Gary, IN
Hartsgrove Youth & Recreation, Rome, OH
Hazel Crest Baseball Association, Hazel Crest, IL
Heartland Community Development, Inglewood, CA
Heirs the 3rd Generation, Chicago, IL
Hewitt Richardson Sr. Community Development Corporation, Houston, TX
HGDC Childcare Center, Inc., Chicago Heights, IL
Hispanic Lawyers Scholarship Fund of Illinois, Flossmoor, IL
Hogar De Cristo, New York, NY
Holiday Productions, Winnetra, IL
Holistic Community Life Centers, Southfield, MI
Homeland Missions, Inc., Marion, IN
Homer Young Guns Wrestling Club, Inc., Albion, MI
Hope for the Animals, Inc., Tulsa, OK
Hopebuilders International, Dallas, TX
Houston Business & Professional Mens Foundation, Incorporated, Houston, TX
Huapu International Cultural & Educational Exchange Fund, San Francisco, CA
Human Spirit Foundation, Inc., Pickerington, OH
Hy Meyer Fund, Skokie, IL
Impact Group, Inc., Vienna, VA
In the Spirit of the American Indian Foundation, Akron, OH
Indian River Institute, Ft. Pierce, FL
Indiana Educational Progress Alliance Organization, Indianapolis, IN
Indiana Friends of Mission Airmens Fellowship, Inc., Greenwood, IN
Indianapolis Chapter of the Brotherhood Vietnam Veterans, Inc., Indianapolis, IN
Infinity Cultivation Center, Inc., Oak Park, IL
Innocent Rage Foundation, Blue Island, IL
Institute for Applied Research, Atlanta, GA
Interfaith Collaborative for Community Economics Development, Detroit, MI
International Institute of Creative Sciences, Inc., Sacramento, CA
International Network for Cancer Treatment and Research USA, Saint Davids, PA
Jersey Central Art Studios a NJ Nonprofit Corp., Cranford, NJ
Jet Alumni Association Chicago Chapter, Chicago, IL
John and Carl E. Vukusich Memorial Scholarship Trust Fund, Tinley Park, IL
Joshua Generation, Inc., Indianapolis, IN
Juvenile Unknown Mitochondrial Problems Foundation, Ann Arbor, MI
Kairos Growth Development Corporation, Southfield, MI
Kankakee County Bar Foundation, Inc., Bourbonnais, IL
Ken White Musical Productions, Inc., Lawrenceville, GA
Kesher L. Shem, Inc., Chicago, IL
King Size Ideas, Los Angeles, CA
Landing Place, Tyler, TX
Latah County Community Foundation, Inc., Moscow, ID
Lathrop Resident Management Corporation, Chicago, IL
Latoya Rodgers Emergency Fund, Inc., Gary, IN
Laverne Faulkner Foundation, Inc., Prescott Valley, AZ
Leichner-Lerner Foundation, Celebration, FL
Let Us Pray Ministries, Inc., Akron, OH
Lewis Center for the Homeless, Riverside, CA
Liberty Theater Association, Inc., Wellsville, OH
Lifelift, Inc., Margate, FL
Living & Education, Inc., Rosamond, CA
Living Waters Ministries International, Battle Creek, MI
Lotus Community Service, Inc., Redondo Beach, CA
Loveland Community Center, Chicago, IL
M2 Foundation for Kids, Pepper Pike, OH
Marys Little Lambs Christian Day Care, Inc., Chicago, IL
Masjid Al-Hijrah, Cleveland, OH
Mayan Esteem Project, Sun City West, AZ
Maywood Tenants Preservation Corp., Deerfield, IL
MCR Budget Counselors, Inc., Merrilville, IN
Medifund, Inc., Schererville, IN
Melody Ranch Motion Picture Museum, Newhall, CA
Men of Vision, Inc., Toledo, OH
Michael Jordan Golf Youth Program, Inc., Northbrook, IL
Michael Omalley Booster Club, Oakbrook, IL
Middle Passage Institute, Inc., Chicago, IL
Ministers With Vision, Benton Harbor, MI
Ministry Resource Network, Inc., Evansville, IN
Mit Liebe German Shepherd Dog Rescue, Suamico, WI
Mobile Pediatrics Fund, Oakbrook, IL
Motivations, Inc., Peoria, IL
Muncie Center for the Arts, Inc., Muncie, IN
Naperville Foundation for the Arts, Naperville, IL

National Christian Leadership Federation, Dolton, IL
National Lifemap, Inc., Brooklyn, NY
Native American Assured Nutrition to Live Endure & Restore, Mokena, IL
Neighborhood Conservation Corps, Chicago, IL
Neoped Foundation, Inc., Oak Brook, IL
New Beginning Day Care Center, Inc., II, Chicago, IL
New Life Crusade, Inc., Pompano Beach, FL
Nonce Dance Ensemble, Eastpoint, MI
North Beverly Development Coalition, Inc., Chicago, IL
North Franklin Athletic Association, Columbus, OH
Northcoast Bird Adoption & Rehabilitation Center, Aurora, OH
Northeast Community Housing Services, Macomb, MI
Nu Millennium Health & Care Services Corporation, East Saint Louis, IL
Oak Lawn Service Club, Inc., Oak Lawn, IL
Ohio Breeze Fastpitch Softball Association, Medina, OH
On Solid Grounds, N. Charleston, SC
One World Theater Co., Peoria, IL
Oniac Foundation, Chicago, IL
Pacific Vocational Services, Inc., Honolulu, HI
Pansy Productions, Inc., Chicago, IL
Parents for Cerro Gordo Baseball-Softball, Cerro Gordo, IL
Park Place Charities, Inc., Chicago, IL
Parkway Drive Neighborhood Association, Inc., Syracuse, NY
Partners for Bass Lake Resources, Oakhurst, CA
Pass the Word, Central Point, OR
Paw Prints, Inc., Wabash, IN
People of Two Spirits, Chicago, IL
Peoples 1st Health Care, Inc., Chicago, IL
Peoples Programme, Inc., Chicago, IL
Perpetual Help Unlimited, Chicago, IL
Perry Community Foundation, Inc., Perry, GA
Phil White, Ltd., Mentorship Services, Chicago, IL
Pieces, Minneapolis, MN
Plant a Tree Project of Illinois, Inc., Elmwood, IL
Pleasant Valley Softball Association, Bettendorf, IA
Plummer Productions, Inc., Chicago, IL
Power for Living Ministries, Inc., Durham, NC
Powertap Theater Company, Chicago, IL
P R A Y E D, Inc., Peru, IN
Prayer Coalition for Reconciliation, Aurora, IL
Precious Children Remembered, Collins, OH
Professional Backflow Prevention Association, Inc., Huntington, IN
Project Network, San Bernardino, CA
Project Safe Illinois, Inc., Dekalb, IL
Quranic Educational Society, Chicago, IL
R & T Youth Development Center, Incorporated, Gary, IN
R. Deron Black Ministries, Mount Vernon, IN
R-Goal, Inc., Harrisville, RI
Rachels Place Adult Day Care, Aurora, IL
Reap, Incorporated, Hickory Hills, IL
Recycling for Wildlife, Englewood, CO
River of Light Enterprise, Inc., Fredericksburg, VA
River Road Museum — Shell Norco, Norco, LA
Robbins Community Help Agency, Inc., Robbins, IL
Rockbridge Foundation, Inc., Worthington, OH
Rockford Scottish Foundation, Rockford, IL
Rogue Frontier Productions, Chicago, IL
Rose Street Community Center, Inc., Baltimore, MD
S & P Foundation, San Ramon, CA
Samaritan Housing Services, Inc., Chicago, IL
San Miguel Education Foundation, San Miguel, CA
Sanders Enterprise Community Development, Brooklyn, NY
Saturday Morning Sunday School Church, Ltd., Lake City, SC
Sausalito REC ERS, Sausalito, CA
Save Hens Alliance, Chicago, IL
Second Chance Cafe, Benzonia, MI
Senior Sittercise, Inc., Rockford, IL
Shiloh Community Ministries of Atlanta, Inc., Atlanta, GA
Shipley Village Community Development Corporation, Wilmington, DE
Shooting for Success, Inc., Chicago, IL
Sitte, Inc., Chicago, IL
Skills Education and Training, Nashville, TN
South Adams Kids for Success, Inc., Berne, IN
Southern California World Wildlife Museum, Moorpark, CA
Spiritual Renewal Services of Chester County, Kennet Square, PA
Stay the Course, Inc., Chicago, IL
Stewardship and Lifestyle Training Seminars, Inc., Columbus, IN
Stewardship Institute, Hazel Crest, IL
Swallow Cliff Dance Company, Palos Park, IL
Temple of Spiritual and Physical Re-Birth, Inc., Brooklyn, NY
Theatre Vox, Inc., Chicago, IL
Thomas Lewis Gladman Foundation, Inc., Akron, OH
Thompsonville Public School Foundation, Inc., Marion, IL
T O P Foundation, Chicago, IL
Total Life Ministries, Inc., South Bend, IN
Trac Enrichment Center, Inc., Winterville, NC
Triage, Inc., Indianapolis, IN
Truth in Research Foundation, Foster City, CA
Underpriviledged Students of Anthropological Vocations, Inc., Albuquerque, NM
United African American Economic Development Organization, Detroit, MI
Unity Environment Foundation, Carson, CA
Universal Community Center, Los Angeles, CA
Universal Health Association, Chicago, IL
Unlimited Priority Services, Inc., University Park, IL
Upper St. Joseph River Association, Inc., Elkhart, IN
Urbansprite Productions, Chicago, IL
US APB, Inc., Champaign, IL
Valdosta City Schools Foundation, Valdosta, GA
Venture CD, Inc., Houston, TX
Vernon K. Willborg Charitable Trust, Missouri City, TX
Veterans Legal Defense Fund, Springfield, IL
Veterans Park Foundation, Inc., Toledo, OH
Vineyard Pomegrante Locks, Incorporated, Detroit, MI
Vision Care, Richmond, IN
Vision of Hope for Youth, Richmond, CA
Voice Education Foundation, Houston, TX
W P A Section on Interdisciplinary Collaboration, Inc., Buffalo, NY
Wabash County Humane Society, Mt. Carmel, IL
Washtenaw Dance Association, Ann Arbor, MI

Webhood, Inc., Cambridge, MA
Wellness Essentials, Inc., Indianapolis, IN
Wellsprings of Life International, Inc., Holly Hill, FL
Westminister Jefferson Park Housing, Los Angeles, CA
Westsiders, Detroit, MI
Wildflower Resource Network, Inc., Indianapolis, IN
Williamsburg Preservation Corp. II, Peoria, IL
Winning the World Ministries, Forest Park, IL
Wishing Well Foundation, Cleveland, OH
Women for Achievement, Chicago, IL
Women of Zion Outreach Ministry, Inc., Kalamazoo, MI
Womens Connection, Rapid City, SD
Works in Progress Services Work Camp, Inc., Westfield, IN
Xchange Point, Cleveland, OH
You Can Run But You Cannot Hide, Crystal, MN
Youth in Education and Sports, Lincolnwood, IL

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2004–78

The name of an organization that no longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on March 18, 2002, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Independent Insurance Agents Association of Queens and Kings Counties, Inc. Long Island City, NY

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 2004–40

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*
2004-58, 2004-29 I.R.B. *66*
2004-59, 2004-30 I.R.B. *94*
2004-60, 2004-29 I.R.B. *43*
2004-61, 2004-29 I.R.B. *67*
2004-62, 2004-30 I.R.B. *103*
2004-63, 2004-31 I.R.B. *149*
2004-64, 2004-35 I.R.B. *402*
2004-65, 2004-33 I.R.B. *300*
2004-66, 2004-35 I.R.B. *402*
2004-67, 2004-36 I.R.B. *459*
2004-68, 2004-38 I.R.B. *508*
2004-69, 2004-39 I.R.B. *542*
2004-70, 2004-39 I.R.B. *543*
2004-71, 2004-40 I.R.B. *569*
2004-73, 2004-39 I.R.B. *543*
2004-74, 2004-40 I.R.B. *579*
2004-75, 2004-40 I.R.B. *580*
2004-76, 2004-40 I.R.B. *588*
2004-78, 2004-40 I.R.B. *592*

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*
2004-46, 2004-29 I.R.B. *46*
2004-47, 2004-29 I.R.B. *48*
2004-48, 2004-30 I.R.B. *88*
2004-49, 2004-30 I.R.B. *88*
2004-50, 2004-33 I.R.B. *196*
2004-51, 2004-30 I.R.B. *89*
2004-52, 2004-32 I.R.B. *168*
2004-53, 2004-33 I.R.B. *209*
2004-54, 2004-33 I.R.B. *209*
2004-55, 2004-34 I.R.B. *319*
2004-56, 2004-35 I.R.B. *375*
2004-57, 2004-35 I.R.B. *376*
2004-58, 2004-39 I.R.B. *520*
2004-59, 2004-36 I.R.B. *447*
2004-60, 2004-40 I.R.B. *564*
2004-62, 2004-40 I.R.B. *565*

Proposed Regulations:

REG-208246-90, 2004-36 I.R.B. *450*
REG-153841-02, 2004-31 I.R.B. *145*
REG-163679-02, 2004-35 I.R.B. *390*
REG-163909-02, 2004-38 I.R.B. *499*
REG-108637-03, 2004-37 I.R.B. *472*

Proposed Regulations— Continued:

REG-120616-03, 2004-37 I.R.B. *474*
REG-124405-03, 2004-35 I.R.B. *394*
REG-131486-03, 2004-28 I.R.B. *36*
REG-131786-03, 2004-38 I.R.B. *500*
REG-145987-03, 2004-39 I.R.B. *523*
REG-149524-03, 2004-39 I.R.B. *528*
REG-150562-03, 2004-32 I.R.B. *175*
REG-152549-03, 2004-36 I.R.B. *451*
REG-154077-03, 2004-37 I.R.B. *476*
REG-171386-03, 2004-37 I.R.B. *477*
REG-101447-04, 2004-34 I.R.B. *344*
REG-106889-04, 2004-38 I.R.B. *501*
REG-116265-04, 2004-38 I.R.B. *505*
REG-117307-04, 2004-28 I.R.B. *39*
REG-124872-04, 2004-39 I.R.B. *533*
REG-128767-04, 2004-39 I.R.B. *534*
REG-129274-04, 2004-40 I.R.B. *567*
REG-129706-04, 2004-37 I.R.B. *478*
REG-129771-04, 2004-36 I.R.B. *453*
REG-130863-04, 2004-39 I.R.B. *538*
REG-131264-04, 2004-38 I.R.B. *506*
REG-135898-04, 2004-40 I.R.B. *568*
REG-136481-04, 2004-37 I.R.B. *480*

Revenue Procedures:

2004-38, 2004-27 I.R.B. *10*
2004-39, 2004-29 I.R.B. *49*
2004-40, 2004-29 I.R.B. *50*
2004-41, 2004-30 I.R.B. *90*
2004-42, 2004-31 I.R.B. *121*
2004-43, 2004-31 I.R.B. *124*
2004-44, 2004-31 I.R.B. *134*
2004-45, 2004-31 I.R.B. *140*
2004-46, 2004-31 I.R.B. *142*
2004-47, 2004-32 I.R.B. *169*
2004-48, 2004-32 I.R.B. *172*
2004-49, 2004-33 I.R.B. *210*
2004-50, 2004-33 I.R.B. *211*
2004-51, 2004-33 I.R.B. *294*
2004-52, 2004-34 I.R.B. *319*
2004-53, 2004-34 I.R.B. *320*
2004-54, 2004-34 I.R.B. *325*
2004-55, 2004-34 I.R.B. *343*
2004-56, 2004-35 I.R.B. *376*
2004-57, 2004-38 I.R.B. *498*

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*
2004-68, 2004-31 I.R.B. *118*
2004-69, 2004-36 I.R.B. *445*
2004-70, 2004-37 I.R.B. *460*

Revenue Rulings— Continued:

2004-71, 2004-30 I.R.B. *74*
2004-72, 2004-30 I.R.B. *77*
2004-73, 2004-30 I.R.B. *80*
2004-74, 2004-30 I.R.B. *84*
2004-75, 2004-31 I.R.B. *109*
2004-76, 2004-31 I.R.B. *111*
2004-77, 2004-31 I.R.B. *119*
2004-78, 2004-31 I.R.B. *108*
2004-79, 2004-31 I.R.B. *106*
2004-80, 2004-32 I.R.B. *164*
2004-81, 2004-32 I.R.B. *161*
2004-82, 2004-35 I.R.B. *350*
2004-83, 2004-32 I.R.B. *157*
2004-84, 2004-32 I.R.B. *163*
2004-85, 2004-33 I.R.B. *189*
2004-86, 2004-33 I.R.B. *191*
2004-87, 2004-32 I.R.B. *154*
2004-88, 2004-32 I.R.B. *165*
2004-89, 2004-34 I.R.B. *301*
2004-90, 2004-34 I.R.B. *317*
2004-91, 2004-35 I.R.B. *357*
2004-92, 2004-37 I.R.B. *466*
2004-93, 2004-37 I.R.B. *462*
2004-94, 2004-38 I.R.B. *491*
2004-95, 2004-38 I.R.B. *492*
2004-97, 2004-39 I.R.B. *516*

Tax Conventions:

2004-60, 2004-29 I.R.B. *43*

Treasury Decisions:

9131, 2004-27 I.R.B. *2*
9132, 2004-28 I.R.B. *16*
9133, 2004-28 I.R.B. *25*
9134, 2004-30 I.R.B. *70*
9135, 2004-30 I.R.B. *69*
9136, 2004-31 I.R.B. *112*
9137, 2004-34 I.R.B. *308*
9138, 2004-32 I.R.B. *160*
9139, 2004-38 I.R.B. *495*
9140, 2004-32 I.R.B. *159*
9141, 2004-35 I.R.B. *359*
9142, 2004-34 I.R.B. *302*
9143, 2004-36 I.R.B. *442*
9144, 2004-36 I.R.B. *413*
9145, 2004-37 I.R.B. *464*
9146, 2004-36 I.R.B. *408*
9147, 2004-37 I.R.B. *461*
9148, 2004-37 I.R.B. *460*
9149, 2004-38 I.R.B. *494*
9150, 2004-39 I.R.B. *514*
9151, 2004-38 I.R.B. *489*
9152, 2004-39 I.R.B. *509*
9153, 2004-39 I.R.B. *517*
9154, 2004-40 I.R.B. *560*

[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 2004–40

Announcements:

99-76
Obsoleted by
T.D. 9157, 2004-40 I.R.B. *545*

Notices:

98-65
Superseded by
Rev. Proc. 2004-40, 2004-29 I.R.B. *50*

2001-50
Modified by
Rev. Proc. 2004-46, 2004-31 I.R.B. *142*

2004-2
Modified by
Notice 2004-50, 2004-33 I.R.B. *196*
2004-2,
Corrected by
Ann. 2004-67, 2004-36 I.R.B. *459*

Proposed Regulations:

INTL-116-90
Withdrawn by
REG-208246-90, 2004-36 I.R.B. *450*

REG-208254-90
Withdrawn by
REG-136481-04, 2004-37 I.R.B. *480*

REG-104683-00
Partially withdrawn by
Ann. 2004-64, 2004-35 I.R.B. *402*

REG-165579-02
Withdrawn by
Ann. 2004-69, 2004-39 I.R.B. *542*

REG-150562-03
Corrected by
Ann. 2004-68, 2004-38 I.R.B. *508*
Ann. 2004-73, 2004-39 I.R.B. *543*

Revenue Procedures:

79-61
Superseded by
Rev. Proc. 2004-44, 2004-31 I.R.B. *134*

89-37
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

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

Revenue Procedures— Continued:

96-18
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

96-53
Superseded by
Rev. Proc. 2004-40, 2004-29 I.R.B. *50*

96-60
Superseded by
Rev. Proc. 2004-53, 2004-34 I.R.B. *320*

98-41
Superseded by
Rev. Proc. 2004-56, 2004-35 I.R.B. *376*

2000-37
Modified by
Rev. Proc. 2004-51, 2004-33 I.R.B. *294*

2002-9
Modified and amplified by
Rev. Proc. 2004-41, 2004-30 I.R.B. *90*

2003-30
Superseded by
Rev. Proc. 2004-54, 2004-34 I.R.B. *325*

2003-52
Superseded by
Rev. Proc. 2004-50, 2004-33 I.R.B. *211*

2004-4
Modified by
Rev. Proc. 2004-44, 2004-31 I.R.B. *134*

2004-23
Modified by
Rev. Proc. 2004-57, 2004-38 I.R.B. *498*

Revenue Rulings:

54-379
Superseded by
Rev. Rul. 2004-68, 2004-31 I.R.B. *118*

58-120
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

62-60
Amplified by
Rev. Proc. 2004-53, 2004-34 I.R.B. *320*

70-58
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

73-354
Obsoleted by
Rev. Rul. 2004-76, 2004-31 I.R.B. *111*

78-371
Distinguished by
Rev. Rul. 2004-86, 2004-33 I.R.B. *191*

Revenue Rulings— Continued:

79-64
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

80-7
Amplified and clarified by
Rev. Rul. 2004-71, 2004-30 I.R.B. *74*
Rev. Rul. 2004-72, 2004-30 I.R.B. *77*
Rev. Rul. 2004-73, 2004-30 I.R.B. *80*
Rev. Rul. 2004-74, 2004-30 I.R.B. *84*

80-366
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

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

85-70
Amplified and clarified by
Rev. Rul. 2004-71, 2004-30 I.R.B. *74*
Rev. Rul. 2004-72, 2004-30 I.R.B. *77*
Rev. Rul. 2004-73, 2004-30 I.R.B. *80*
Rev. Rul. 2004-74, 2004-30 I.R.B. *84*

92-105
Distinguished by
Rev. Rul. 2004-86, 2004-33 I.R.B. *191*

2004-75
Amplified by
Rev. Rul. 2004-97, 2004-39 I.R.B. *516*

Treasury Decisions:

9031
Removed by
T.D. 9152, 2004-39 I.R.B. *509*

[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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