Internal Revenue bulletin

Bulletin No. 2005-6
February 7, 2005

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2005–6, page 471.

Life insurance contracts. For purposes of determining whether a contract qualifies as a life insurance contract under section 7702 of the Code, and as a modified endowment contract under section 7702A, charges for qualified additional benefits (QABs) are to be taken into account under the expense charge rule of section 7702(c)(3)(B)(ii) rather than under the mortality charge rule of section 7702(c)(3)(B)(i). Issuers whose compliance systems do not currently account for QABs under the expense charge rule of section 7702(c)(3)(B)(ii) are provided alternatives to correct their compliance systems.

Rev. Rul. 2005–7, page 464.

Segregated asset account. For purposes of determining whether a segregated asset account held by an insurance company is adequately diversified pursuant to section 817(h) of the Code, a segregated asset account that invests in a regulated investment company which in turn, holds an interest in another regulated investment company, may look through to the individual assets of both regulated investment companies.

Rev. Rul. 2005–8, page 466.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for February 2005.

Rev. Rul. 2005–9, page 470.

Bankruptcy cases; definition of "pending". This ruling discusses the definition of "pending" regarding bankruptcy cases for purposes of the relief from the imposition of certain penalties provided under section 6658 of the Code.

T.D. 9171, page 452.

Final regulations involve the new markets tax credit under section 45D of the Code. A taxpayer making a qualified equity investment in a qualified community development entity that has received a new markets tax credit allocation may claim a 5–percent tax credit with respect to the qualified equity investment on each of the first 3 credit allowance dates and a 6–percent tax credit with respect to the qualified equity investment on each of the remaining 4 credit allowance dates.

Notice 2005–10, page 474.

This document provides guidance under new section 965 of the Code enacted by the American Jobs Creation Act of 2004. In general, and subject to limitations and conditions, section 965(a) provides that a corporation that is a U.S. shareholder of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent dividends received deduction (DRD) with respect to certain cash dividends it receives from its CFCs. Section 965(f) provides that taxpayers may elect the application of section 965 for either the taxpayer's last taxable year which begins before October 22, 2004, or the taxpayer's first taxable year which begins during the one-year period beginning on October 22, 2004.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 491.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ESTATE TAX

T.D. 9172, page 468.
Final regulations under section 2032 of the Code concern the election to value a decedent's gross estate on the alternate valuation date. The final regulations reflect a change to the law made by the Deficit Reduction Act of 1984. As a result of the final regulations, section 301.9100–6T(b) of the regulations will be removed. Please note: the preamble of the final regulations describes a change in the IRS's position on the availability of relief to make the section 2032 election or protective election, and the section 2056A(d) election under sections 301.9100–1 and 301.9100–3 of the regulations.

EMPLOYMENT TAX

REG–152945–04, page 484.
Proposed regulations under section 3402 of the Code set forth rules for withholding income tax on supplemental wages paid by an employer to an employee that, together with all previous supplemental wages paid during the calendar year to the employee by the employer, exceed one million dollars. The proposed regulations also update the rules that apply in determining liability for income tax withholding with respect to other supplemental wage payments.

ADMINISTRATIVE

Rev. Rul. 2005–9, page 470.
Bankruptcy cases; definition of "pending". This ruling discusses the definition of "pending" regarding bankruptcy cases for purposes of the relief from the imposition of certain penalties provided under section 6658 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 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 45D.—New Markets Tax Credit

26 CFR 1.45D–1: New markets tax credit.

T.D. 9171

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

New Markets Tax Credit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: These regulations finalize the rules relating to the new markets tax credit under section 45D and replace the temporary regulations which expire on December 23, 2004. A taxpayer making a qualified equity investment in a qualified community development entity that has received a new markets tax credit allocation may claim a 5-percent tax credit with respect to the qualified equity investment on each of the first 3 credit allowance dates and a 6-percent tax credit with respect to the qualified equity investment on each of the remaining 4 credit allowance dates.

DATES: *Effective Date*: These regulations are effective December 22, 2004.

Date of Applicability: For date of applicability, see §1.45D–1(h).

FOR FURTHER INFORMATION CONTACT: Paul F. Handleman or Lauren R. Taylor, (202) 622–3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has 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 1545–1765. Responses to this collection of information are mandatory so that a taxpayer may claim a new markets tax credit on each credit allowance date during the 7-year credit period and report compliance with the requirements of section 45D to the Secretary.

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 varies from 15 minutes to 5 hours, depending on individual circumstances, with an estimated average of 2.5 hours.

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 amends 26 CFR part 1 to provide rules relating to the new markets tax credit under section 45D of the Internal Revenue Code (Code). On December 26, 2001, the IRS published in the **Federal Register** temporary and proposed regulations (the 2001 temporary regulations) (T.D. 8971, 2002–1 C.B. 308 [66 FR 66307]), (REG–119436–01, 2002–1 C.B. 377 [66 FR 66376]) . On March 11, 2004, the IRS published in the **Federal Register** temporary and proposed regulations revising and clarifying the 2001 temporary regulations (the 2004 temporary regulations) (T.D. 9116, 2004–14 I.R.B. 674 [69 FR 11507]), (REG–115471–03, 2004–14 I.R.B. 706 [69 FR 11561]). On March 14, 2002, and June 2, 2004, the IRS and Treasury Department held public hearings on the 2001 temporary regulations and the 2004 temporary regulations, respectively. Written and electronic comments responding to the temporary regulations and notices of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below.

Section 45D was added to the Code by section 121(a) of the Community Renewal Tax Relief Act of 2000 (Pub. L. 106–554). The Secretary has delegated certain administrative, application, allocation, monitoring, and other programmatic functions relating to the new markets tax credit program to the Under Secretary (Domestic Finance), who in turn has delegated those functions to the Community Development Financial Institutions Fund.

Sections 221 and 223 of the American Jobs Creation Act of 2004 (Pub. L. 108–357) amended the definition of a low-income community under section 45D(e). This document does not provide guidance on these amendments. The IRS and Treasury Department are studying the amendments for guidance in the near future.

Explanation of Provisions

General Overview

Taxpayers may claim a new markets tax credit on a credit allowance date in an amount equal to the applicable percentage of the taxpayer's qualified equity investment in a qualified community development entity (CDE). The credit allowance date for any qualified equity investment is the date on which the investment is initially made and each of the 6 anniversary dates thereafter. The applicable percentage is 5 percent for the first 3 credit allowance dates and 6 percent for the remaining credit allowance dates.

A CDE is any domestic corporation or partnership if: (1) the primary mission of the entity is serving or providing investment capital for low-income communities or low-income persons; (2) the entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity; and (3) the entity is certified by the Secretary for purposes of section 45D as being a CDE.

The new markets tax credit may be claimed only for a qualified equity investment in a CDE. A qualified equity investment is any equity investment in a CDE for which the CDE has received an allocation from the Secretary if, among other things, the CDE uses substantially all of the cash from the investment to make qualified low-income community investments. Under a safe harbor, the substantially-all requirement is treated as met if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments.

Qualified low-income community investments consist of: (1) any capital or equity investment in, or loan to, any qualified active low-income community business; (2) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; (3) financial counseling and other services to businesses located in, and residents of, low-income communities; and (4) certain equity investments in, or loans to, a CDE.

In general, a qualified active low-income community business is a corporation or a partnership if for the taxable year: (1) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community; (2) a substantial portion of the use of the tangible property of the entity is within any low-income community; (3) a substantial portion of the services performed for the entity by its employees is performed in any low-income community; (4) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain collectibles; and (5) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain nonqualified financial property.

A recapture event requiring an investor to recapture credits previously taken occurs for an equity investment in a CDE if the CDE: (1) ceases to be a CDE; (2) ceases to use substantially all of the proceeds of the equity investment for qualified low-income community investments; or (3) redeems the investor's equity investment. In addition, the investor's basis in any qualified equity investment is reduced by the amount of the new markets tax credit.

Substantially All

As indicated above, a CDE must use substantially all of the cash from a qualified equity investment to make qualified low-income community investments. Section 1.45D–1T(c)(5)(i) provides that the substantially-all requirement is treated as satisfied for an annual period if either the direct-tracing calculation under §1.45D–1T(c)(5)(ii), or the safe harbor calculation under §1.45D–1T(c)(5)(iii), is performed every six months and the average of the two calculations for the annual period is at least 85 percent. The final regulations clarify that a CDE may choose the same two testing dates for all qualified equity investments regardless of the date each qualified equity investment was initially made. To conform the annual testing requirement with the 12-month time limit for making qualified low-income community investments, the final regulations provide that for the first annual period, the substantially-all calculation may be performed on a single testing date. The final regulations also amend the beginning of the 12-month period for making qualified low-income community investments to provide that the 12-month period begins on the same date as the beginning of the first annual period of the 7-year credit period.

Section 1.45D–1T(d)(3) provides that reserves (not in excess of 5 percent of the taxpayer's cash investment under §1.45D–1T(b)(4)) maintained by the CDE for loan losses or for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment. In response to comments, the final regulations provide that reserves include fees paid to third parties to protect against loss of all or a portion of the principal of, or interest on, on a loan that is a qualified low-income community investment.

Qualified Active Low-Income Community Business

As indicated above, qualified low-income community investments include any capital or equity investment in, or loan to, any qualified active low-income community business. Under §1.45D–1T (d)(4)(i)(B), an entity is a qualified active low-income community business only if, among other requirements, at least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. In response to comments, the final regulations provide an example of how the tangible property test applies to property that is used both outside and inside a low-income community. The example demonstrates that use is measured based on the entity's business hours of operation and does not include non-business hours.

Under section 45D(d)(2)(C), a qualified active low-income community business includes any trade or business that would qualify as a qualified active low-income community business if such trade or business were separately incorporated. Commentators requested clarification of how this rule applies.

The final regulations provide that a CDE may treat any trade or business (or portion thereof) as a qualified active low-income community business if the trade or business (or portion thereof) would meet the requirements to be a qualified active low-income community business if the trade or business (or portion thereof) were separately incorporated and a complete and separate set of books and records is maintained for that trade or business (or portion thereof). The final regulations further provide, however, that under this rule a CDE's capital or equity investment or loan is not a qualified low-income community investment to the extent the proceeds of the investment or loan are not used for the trade or business (or portion thereof) that is treated as a qualified active low-income community business.

Section §1.45D–1T(d)(4)(iv) provides that an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, receive donations) within 3 years after the date the investment or loan is made. The final regulations amend this rule with respect to a nonprofit corporation by providing that the nonprofit corporation must be engaged in an activity that furthers its purpose as a nonprofit corporation within the 3-year period.

Under §1.45D–1T(d)(4)(i)(E), an entity is a qualified active low-income community business only if, among other requirements, less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property (as defined in section 1397C(e)). Section 1397C(e)(1) contains an exception to the definition of nonqualified financial property for reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The final regulations provide that, for these purposes, the proceeds of a capital or equity investment or loan by a CDE that will be expended on construction of real property within 12 months after the date the investment or loan is made qualify as a reasonable amount of working capital.

Section 45D(d)(3)(A) provides that the rental to others of real property located in any low-income community is treated as a qualified business only if, among other requirements, there are substantial improvements located on such property. Commentators requested clarification of the term *substantial improvements*. The final regulations provide that the term *substantial improvements* means improvements the cost basis of which equals or exceeds 50 percent of the cost basis of the land on which the improvements are located and the costs of which are incurred after the date the CDE makes the investment or loan. In addition, the final regulations provide that a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment to the extent any lessee of the real property is not a qualified business.

Recapture

As indicated above, there is a recapture event with respect to an equity investment in a CDE if such investment is redeemed by the CDE. Commentators requested clarification of when distributions by a CDE to its investors will be treated as redemptions. The final regulations provide guidance on when a distribution by a CDE that is a corporation for Federal tax purposes will be treated as a redemption.

Some commentators suggested that, in the case of a CDE that is treated as a partnership for Federal tax purposes, a redemption should be limited to purchases by the CDE of a partner's capital interest. Alternatively, commentators requested guidance on how to distinguish between a return of capital and a distribution of profits if a return of capital is treated as a redemption. In response to comments, the final regulations provide a safe harbor under which cash distributions by a partnership will not be treated as a redemption. Under the safe harbor, a *pro rata* cash distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year will not be treated as a redemption if the distribution does not exceed the CDE's operating income (as defined in the final regulations) for the taxable year. In addition, a non-*pro rata de minimis* cash distribution by a CDE to a partner or partners during the taxable year will be not treated as a redemption. A non-*pro rata de minimis* cash distribution may not exceed the lesser of 5 percent of the CDE's operating income for that taxable year or 10 percent of the partner's capital interest in the CDE.

Commentators suggested that cure periods be provided to enable CDEs to correct any noncompliance with the requirements under section 45D. One commentator suggested that a cure period be provided to allow an investment that no longer qualifies as a qualified low-income community investment to be replaced with a qualifying investment by the end of the calendar year following the year the original investment lost its status as a qualified low-income community investment. Other commentators suggested that, if a qualified equity investment fails the substantially-all requirement, the failure should not be a recapture event if the CDE corrects the failure within 6 months after the date the CDE discovers (or reasonably should have discovered) the failure. The final regulations provide that, if a qualified equity investment fails the substantially-all requirement, the failure is not a recapture event if the CDE corrects the failure within 6 months after the date the CDE becomes aware (or reasonably should have become aware) of the failure. Only one correction is permitted for each qualified equity investment during the 7-year credit period.

Other Issues

Section 45D(i)(1) authorizes the Secretary to prescribe regulations as may be appropriate to carry out section 45D including regulations that limit the new markets tax credit for investments that are directly or indirectly subsidized by other Federal tax benefits (including the low-income housing credit under section 42 and the exclusion from gross income under section 103). The final regulations do not prohibit a CDE from purchasing tax-exempt bonds because tax-exempt financing provides a subsidy to borrowers and not bondholders. However, the final regulations provide that if a CDE makes a capital or equity investment or loan with respect to a qualified low-income building under section 42, the investment or loan is not a qualified low-income community investment to the extent the building's eligible basis under section 42(d) is financed by the proceeds of the investment or loan.

Effective Dates

The final regulations are effective December 22, 2004, and may be applied by taxpayers before December 22, 2004. However, both the definition of the term *substantial improvements* and the requirement that each lessee be a qualified business apply to qualified low-income community investments made on or after February 22, 2005.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is 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 Code, the notices of proposed rulemaking preceding these regulations were 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 Paul F. Handleman, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. 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 * * *

Section 1.45D–1 also issued under 26 U.S.C. 45D(i); * * *

Par. 2. Section 1.45D–1 is added to read as follows:

§1.45D–1 New markets tax credit.

(a) *Table of contents*. This paragraph lists the headings that appear in §1.45D–1.

(iii) Manner of claiming new markets tax credit.

(iv) Reporting recapture tax.

(3) Other Federal tax benefits.

(i) In general.

(ii) Low-income housing credit.

(4) Bankruptcy of CDE.

(h) Effective dates.

(1) In general.

(2) Exception for certain provisions.

(b) *Allowance of credit*—(1) *In general*. For purposes of the general business credit under section 38, a taxpayer holding a qualified equity investment on a credit allowance date which occurs during the taxable year may claim the new markets tax credit determined under section 45D and this section for such taxable year in an amount equal to the applicable percentage of the amount paid to a qualified community development entity (CDE) for such investment at its original issue. *Qualified equity investment* is defined in paragraph (c) of this section. *Credit allowance date* is defined in paragraph (b)(2) of this section. *Applicable percentage* is defined in paragraph (b)(3) of this section. A *CDE* is a qualified community development entity as defined in section 45D(c). The amount paid at original issue is determined under paragraph (b)(4) of this section.

(2) *Credit allowance date*. The term *credit allowance date* means, with respect to any qualified equity investment—

(i) The date on which the investment is initially made; and

(ii) Each of the 6 anniversary dates of such date thereafter.

(3) *Applicable percentage*. The *applicable percentage* is 5 percent for the first 3 credit allowance dates and 6 percent for the other 4 credit allowance dates.

(4) *Amount paid at original issue*. The amount paid to the CDE for a qualified equity investment at its original issue consists of all amounts paid by the taxpayer to, or on behalf of, the CDE (including any underwriter's fees) to purchase the investment at its original issue.

(c) *Qualified equity investment*—(1) *In general*. The term *qualified equity investment* means any equity investment (as defined in paragraph (c)(2) of this section) in a CDE if—

(i) The investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash;

(ii) Substantially all (as defined in paragraph (c)(5) of this section) of such cash is used by the CDE to make qualified low-income community investments (as defined in paragraph (d)(1) of this section); and

(iii) The investment is designated for purposes of section 45D and this section by the CDE on its books and records using any reasonable method.

(2) *Equity investment*. The term *equity investment* means any stock (other than nonqualified preferred stock as defined in section 351(g)(2)) in an entity that is a corporation for Federal tax purposes and any capital interest in an entity that is a partnership for Federal tax purposes. See §§301.7701–1 through 301.7701–3 of this chapter for rules governing when a business entity, such as a business trust or limited liability company, is classified as a corporation or a partnership for Federal tax purposes.

(3) *Equity investments made prior to allocation*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, an equity investment in an entity is not eligible to be designated as a qualified equity investment if it is made before the entity enters into an allocation agreement with the Secretary. An *allocation agreement* is an agreement between the Secretary and a CDE relating to a new markets tax credit allocation under section 45D(f)(2).

(ii) *Exceptions*. Notwithstanding paragraph (c)(3)(i) of this section, an equity investment in an entity is eligible to be designated as a qualified equity investment under paragraph (c)(1)(iii) of this section if—

(A) *Allocation applications submitted by August 29, 2002*.

(*1*) The equity investment is made on or after April 20, 2001;

(*2*) The designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Secretary no later than August 29, 2002; and

(*3*) The equity investment otherwise satisfies the requirements of section 45D and this section; or

(B) *Other allocation applications*.

(*1*) The equity investment is made on or after the date the Secretary publishes a Notice of Allocation Availability (NOAA) in the **Federal Register**;

(*2*) The designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Secretary under that NOAA; and

(*3*) The equity investment otherwise satisfies the requirements of section 45D and this section.

(iii) *Failure to receive allocation*. For purposes of paragraph (c)(3)(ii)(A) of this section, if the entity in which the equity investment is made does not receive an allocation pursuant to an allocation application submitted no later than August 29, 2002, the equity investment will not be eligible to be designated as a qualified equity investment. For purposes of paragraph (c)(3)(ii)(B) of this section, if the entity in which the equity investment is made does not receive an allocation under the NOAA described in paragraph (c)(3)(ii)(B)(*1*) of this section, the equity investment will not be eligible to be designated as a qualified equity investment.

(iv) *Initial investment date*. If an equity investment is designated as a qualified equity investment in accordance with paragraph (c)(3)(ii) of this section, the investment is treated as initially made on the effective date of the allocation agreement between the CDE and the Secretary.

(4) *Limitations*—(i) *In general*. The term *qualified equity investment* does not include—

(A) Any equity investment issued by a CDE more than 5 years after the date the CDE enters into an allocation agreement (as defined in paragraph (c)(3)(i) of this section) with the Secretary; and

(B) Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2).

(ii) *Allocation limitation.* The maximum amount of equity investments issued by a CDE that may be designated under paragraph (c)(1)(iii) of this section by the CDE may not exceed the portion of the limitation amount allocated to the CDE by the Secretary under section 45D(f)(2).

(5) *Substantially all*—(i) *In general*. Except as provided in paragraph (c)(5)(v) of this section, the term *substantially all* means at least 85 percent. The substantially-all requirement must be satisfied for each annual period in the 7-year credit period using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section. For

the first annual period, the substantially-all requirement is treated as satisfied if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe-harbor calculation under paragraph (c)(5)(iii) of this section, is performed on a single testing date and the result of the calculation is at least 85 percent. For each annual period other than the first annual period, the substantially-all requirement is treated as satisfied if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section, is performed every six months and the average of the two calculations for the annual period is at least 85 percent. For example, the CDE may choose the same two testing dates for all qualified equity investments regardless of the date each qualified equity investment was initially made under paragraph (b)(2)(i) of this section, provided the testing dates are six months apart. The use of the direct-tracing calculation under paragraph (c)(5)(ii) of this section (or the safe harbor calculation under paragraph (c)(5)(iii) of this section) for an annual period does not preclude the use of the safe harbor calculation under paragraph (c)(5)(iii) of this section (or the direct-tracing calculation under paragraph (c)(5)(ii) of this section) for another annual period, provided that a CDE that switches to a direct-tracing calculation must substantiate that the taxpayer's investment is directly traceable to qualified low-income community investments from the time of the CDE's initial investment in a qualified low-income community investment. For purposes of this paragraph (c)(5)(i), the *7-year credit period* means the period of 7 years beginning on the date the qualified equity investment is initially made. See paragraph (c)(6) of this section for circumstances in which a CDE may treat more than one equity investment as a single qualified equity investment.

(ii) *Direct-tracing calculation*. The substantially-all requirement is satisfied if at least 85 percent of the taxpayer's investment is directly traceable to qualified low-income community investments as defined in paragraph (d)(1) of this section. The direct-tracing calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of the qualified low-income community investments that are directly traceable to the taxpayer's cash investment, and the denominator of which is the amount of the taxpayer's cash investment under paragraph (b)(4) of this section. For purposes of this paragraph (c)(5)(ii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. See paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iii) *Safe harbor calculation*. The substantially-all requirement is satisfied if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments as defined in paragraph (d)(1) of this section. The safe harbor calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of its qualified low-income community investments, and the denominator of which is the CDE's aggregate cost basis determined under section 1012 in all of its assets. For purposes of this paragraph (c)(5)(iii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. See paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iv) *Time limit for making investments*. The taxpayer's cash investment received by a CDE is treated as invested in a qualified low-income community investment as defined in paragraph (d)(1) of this section only to the extent that the cash is so invested within the 12-month period beginning on the date the cash is paid by the taxpayer (directly or through an underwriter) to the CDE.

(v) *Reduced substantially-all percentage*. For purposes of the substantially-all requirement (including the direct-tracing calculation under paragraph (c)(5)(ii) of this section and the safe harbor calculation under paragraph (c)(5)(iii) of this section), 85 percent is reduced to 75 percent for the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section).

(vi) *Examples*. The following examples illustrate an application of this paragraph (c)(5):

Example 1. X is a partnership and a CDE that has received a $1 million new markets tax credit allocation from the Secretary. On September 1, 2004, X uses a line of credit from a bank to fund a $1 million loan to Y. The loan is a qualified low-income community investment under paragraph (d)(1) of this section. On September 5, 2004, A pays $1 million to acquire a capital interest in X. X uses the proceeds of A's equity investment to pay off the $1 million line of credit that was used to fund the loan to Y. X's aggregate gross assets consist of the $1 million loan to Y and $100,000 in other assets. A's equity investment in X does not satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section using the direct-tracing calculation under paragraph (c)(5)(ii) of this section because the cash from A's equity investment is not used to make X's loan to Y. However, A's equity investment in X satisfies the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section because at least 85 percent of X's aggregate gross assets are invested in qualified low-income community investments.

Example 2. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On August 1, 2004, A pays $100,000 for a capital interest in X. On August 5, 2004, X uses the proceeds of A's equity investment to make an equity investment in Y. X controls Y within the meaning of paragraph (d)(6)(ii)(B) of this section. For the annual period ending July 31, 2005, Y is a qualified active low-income community business (as defined in paragraph (d)(4) of this section). Thus, for that period, A's equity investment satisfies the substantially-all requirement under paragraph (c)(5)(i) of this section using the direct-tracing calculation under paragraph (c)(5)(ii) of this section. For the annual period ending July 31, 2006, Y no longer is a qualified active low-income community business. Thus, for that period, A's equity investment does not satisfy the substantially-all requirement using the direct-tracing calculation. However, during the entire annual period ending July 31, 2006, X's remaining assets are invested in qualified low-income community investments with an aggregate cost basis of $900,000. Consequently, for the annual period ending July 31, 2006, at least 85 percent of X's aggregate gross assets are invested in qualified low-income community investments. Thus, for the annual period ending July 31, 2006, A's equity investment satisfies the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section.

Example 3. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On August 1, 2004, A and B each pay $100,000 for a capital interest in X. X does not treat A's and B's equity investments as one qualified equity investment under paragraph (c)(6) of this section. On September 1, 2004, X uses the proceeds of A's equity investment to make an equity investment in Y and X uses the proceeds of B's equity investment to make an equity investment in Z. X has no assets other than its investments in Y and Z. X controls Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. For the annual period ending July 31, 2005, Y and Z are qualified active low-income community businesses (as defined in paragraph (d)(4) of this section). Thus, for the annual period ending July 31, 2005, A's and B's equity investments satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. For the annual period ending July 31, 2006, Y, but not Z, is a qualified active low-income community business. Thus, for the annual period ending July 31, 2006—

(1) X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section;

(2) A's equity investment satisfies the substantially-all requirement using the direct-tracing calculation because A's equity investment is directly traceable to Y; and

(3) B's equity investment does not satisfy the substantially-all requirement because B's equity investment is traceable to Z.

Example 4. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On November 1, 2004, A pays $100,000 for a capital interest in X. On December 1, 2004, B pays $100,000 for a capital interest in X. On December 31, 2004, X uses $85,000 from A's equity investment and $85,000 from B's equity investment to make a $170,000 equity investment in Y, a qualified active low-income community business (as defined in paragraph (d)(4) of this section). X has no assets other than its investment in Y. X determines whether A's and B's equity investments satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section on December 31, 2004. The calculation for A's and B's equity investments is 85 percent using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. Therefore, for the annual periods ending October 31, 2005, and November 30, 2005, A's and B's equity investments, respectively, satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section. For the subsequent annual period, X performs its calculations on December 31, 2005, and June 30, 2006. The average of the two calculations on December 31, 2005, and June 30, 2006, is 85 percent using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. Therefore, for the annual periods ending October 31, 2006, and November 30, 2006, A's and B's equity investments, respectively, satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section.

(6) *Aggregation of equity investments*. A CDE may treat any qualified equity investments issued on the same day as one qualified equity investment. If a CDE aggregates equity investments under this paragraph (c)(6), the rules in this section shall be construed in a manner consistent with that treatment.

(7) *Subsequent purchasers*. A qualified equity investment includes any equity investment that would (but for paragraph (c)(1)(i) of this section) be a qualified equity investment in the hands of the taxpayer if the investment was a qualified equity investment in the hands of a prior holder.

(d) *Qualified low-income community investments*—(1) *In general*. The term *qualified low-income community investment* means any of the following:

(i) *Investment in a qualified active low-income community business*. Any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in paragraph (d)(4) of this section).

(ii) *Purchase of certain loans from CDEs*—(A) *In general*. The purchase by a CDE (the ultimate CDE) from another CDE (whether or not that CDE has received an allocation from the Secretary under section 45D(f)(2)) of any loan made by such entity that is a qualified low-income community investment. A loan purchased by the ultimate CDE from another CDE is a qualified low-income community investment if it qualifies as a qualified low-income community investment either—

(*1*) At the time the loan was made; or

(*2*) At the time the ultimate CDE purchases the loan.

(B) *Certain loans made before CDE certification*. For purposes of paragraph (d)(1)(ii)(A) of this section, a loan by an entity is treated as made by a CDE, notwithstanding that the entity was not a CDE at the time it made the loan, if the entity is a CDE at the time it sells the loan.

(C) *Intermediary CDEs*. For purposes of paragraph (d)(1)(ii)(A) of this section, the purchase of a loan by the ultimate CDE from a CDE that did not make the loan (the second CDE) is treated as a purchase of the loan by the ultimate CDE from the CDE that made the loan (the originating CDE) if—

(*1*) The second CDE purchased the loan from the originating CDE (or from another CDE); and

(*2*) Each entity that sold the loan was a CDE at the time it sold the loan.

(D) *Examples*. The following examples illustrate an application of this paragraph (d)(1)(ii):

Example 1. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. Y, a corporation, made a $500,000 loan to Z in 1999. In January of 2004, Y is certified as a CDE. On September 1, 2004, X purchases the loan from Y. At the time X purchases the loan, Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Accordingly, the loan purchased by X from Y is a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (B) of this section.

Example 2. The facts are the same as in *Example 1* except that on February 1, 2004, Y sells the loan to W and on September 1, 2004, W sells the loan to X. W is a CDE. Under paragraph (d)(1)(ii)(C) of this section, X's purchase of the loan from W is treated as the purchase of the loan from Y. Accordingly, the loan purchased by X from W is a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (C) of this section.

Example 3. The facts are the same as in *Example 2* except that W is not a CDE. Because W was not a CDE at the time it sold the loan to X, the purchase of the loan by X from W is not a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (C) of this section.

(iii) *Financial counseling and other services*. Financial counseling and other services (as defined in paragraph (d)(7) of this section) provided to any qualified active low–income community business, or to any residents of a low–income community (as defined in section 45D(e)).

(iv) *Investments in other CDEs*—(A) *In general*. Any equity investment in, or loan to, any CDE (the second CDE) by a CDE (the primary CDE), but only to the extent that the second CDE uses the proceeds of the investment or loan—

(*1*) In a manner—

(*i*) That is described in paragraph (d)(1)(i) or (iii) of this section; and

(*ii*) That would constitute a qualified low-income community investment if it were made directly by the primary CDE;

(*2*) To make an equity investment in, or loan to, a third CDE that uses such proceeds in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section; or

(*3*) To make an equity investment in, or loan to, a third CDE that uses such proceeds to make an equity investment in, or loan to, a fourth CDE that uses such proceeds in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section.

(B) *Examples*. The following examples illustrate an application of paragraph (d)(1)(iv)(A) of this section:

Example 1. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, X uses $975,000 to make an equity investment in Y. Y is a corporation and a CDE. On October 1, 2004, Y uses $950,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Of X's equity investment in Y, $950,000 is a qualified low-income community investment under paragraph (d)(1)(iv)(A)(*1*) of this section.

Example 2. W is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, W uses $975,000 to make an equity investment in X. On October 1, 2004, X uses $950,000 from W's equity investment to make an equity investment in Y. X and Y are corporations and CDEs. On October 5, 2004, Y uses $925,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Of W's equity investment in X, $925,000 is a qualified low-income community investment under paragraph (d)(1)(iv)(A)(*2*) of this section because X uses proceeds of W's equity investment to make an equity investment in Y, which uses $925,000 of the proceeds in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section.

Example 3. U is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, U uses $975,000 to make an equity investment in V. On October 1, 2004, V uses $950,000 from U's equity investment to make an equity investment in W. On October 5, 2004, W uses $925,000 from V's equity investment to make an equity investment in X. On November 1, 2004, X uses $900,000 from W's equity investment to make an equity investment in Y. V, W, X, and Y are corporations and CDEs. On November 5, 2004, Y uses $875,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. U's equity investment in V is not a qualified low-income community investment because X does not use proceeds of W's equity investment in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section.

(2) *Payments of, or for, capital, equity or principal*—(i) *In general*. Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least equal to such original cost basis, then an amount equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(ii) *Subsequent reinvestments*. In applying paragraph (d)(2)(i) of this section to subsequent reinvestments, the original cost basis is reduced by the amount (if any) by which the original cost basis exceeds the amount determined to be continuously invested in a qualified low-income community investment.

(iii) *Special rule for loans*. Periodic amounts received during a calendar year as repayment of principal on a loan that is a qualified low-income community investment are treated as continuously invested in a qualified low-income community investment if the amounts are reinvested in another qualified low-income community investment by the end of the following calendar year.

(iv) *Example*. The application of paragraphs (d)(2)(i) and (ii) of this section is illustrated by the following example:

Example. On April 1, 2003, A, B, and C each pay $100,000 to acquire a capital interest in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X treats the 3 partnership interests as one qualified equity investment under paragraph (c)(6) of this section. In August 2003, X uses the $300,000 to make a qualified low-income community investment under paragraph (d)(1) of this section. In August 2005, the qualified low-income community investment is redeemed for $250,000. In February 2006, X reinvests $230,000 of the $250,000 in a second qualified low-income community investment and uses the remaining $20,000 for operating expenses. Under paragraph (d)(2)(i) of this section, $280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment. In December 2008, X sells the second qualified low-income community investment and receives $400,000. In March 2009, X reinvests $320,000 of the $400,000 in a third qualified low-income community investment. Under paragraphs (d)(2)(i) and (ii) of this section, $280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment ($40,000 is treated as invested in another qualified low-income community investment in March 2009).

(3) *Special rule for reserves*. Reserves (not in excess of 5 percent of the taxpayer's cash investment under paragraph (b)(4) of this section) maintained by the CDE for loan losses or for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment under paragraph (d)(1) of this section. Reserves include fees paid to third parties to protect against loss of all or a portion of the principal of, or interest on, a loan that is a qualified low-income community investment.

(4) *Qualified active low-income community business*—(i) *In general*. The term *qualified active low-income community business* means, with respect to any taxable year, a corporation (including a nonprofit corporation) or a partnership engaged in the active conduct of a qualified business (as defined in paragraph (d)(5 of this section), if the requirements in paragraphs (d)(4)(i)(A), (B), (C), (D), and (E) of this section are met. Solely for purposes of this section, a nonprofit corporation will be deemed to be engaged in the active conduct of a trade or business if it is engaged in an activity that furthers its purpose as a nonprofit corporation.

(A) *Gross-income requirement*. At least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within any low-income community (as defined in section 45D(e)). An entity is deemed to satisfy this paragraph (d)(4)(i)(A) if the entity meets the requirements of either paragraph (d)(4)(i)(B) or (C) of this section, if "50 percent" is applied instead of *40 percent*. In addition, an entity may satisfy this paragraph (d)(4)(i)(A) based on all the facts and circumstances. See paragraph (d)(4)(iv) of this section for certain circumstances in which an entity will be treated as engaged in the active conduct of a trade or business.

(B) *Use of tangible property*—(*1*) *In general*. At least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under section 1012. Property leased by the entity is valued at a reasonable amount established by the entity.

(*2*) *Example*. The application of paragraph (d)(4)(i)(B)(*1*) of this section is illustrated by the following example:

Example. X is a corporation engaged in the business of moving and hauling scrap metal. X operates its business from a building and an adjoining parking lot that X owns. The building and the parking lot are located in a low-income community (as defined in section 45D(e)). X's cost basis under section 1012 for the building and parking lot is $200,000. During the taxable year, X operates its business 10 hours a day, 6 days a week. X owns and uses 40 trucks in its business, which, on average, are used 6 hours a day outside a low-income community and 4 hours a day inside a low-income community (including time in the parking lot). The cost basis under section 1012 of each truck is $25,000. During non-business hours, the trucks are parked in the lot. Only X's 10-hour business days are used in calculating the use of tangible property percentage under paragraph (d)(4)(i)(B)(*1*) of this section. Thus, the numerator of the tangible property calculation is $600,000 (4/10 of $1,000,000 (the $25,000 cost basis of each truck times 40 trucks) plus $200,000 (the cost basis of the building and parking lot)) and the denominator is $1,200,000 (the total cost basis of the trucks, building, and parking lot), resulting in 50 percent of the use of X's tangible property being within a low-income community. Consequently, X satisfies the 40 percent use of tangible property test under paragraph (d)(4)(i)(B)(*1*) of this section.

(C) *Services performed*. At least 40 percent of the services performed for such entity by its employees are performed in a low-income community. This percentage is determined based on a fraction the numerator of which is the total amount paid by the entity for employee services performed in a low-income community during the taxable year and the denominator of which is the total amount paid by the entity for employee services during the taxable year. If the entity has no employees, the entity is deemed to satisfy this paragraph (d)(4)(i)(C), and paragraph (d)(4)(i)(A) of this section, if the entity meets the requirement of paragraph (d)(4)(i)(B) of this section if "85 percent" is applied instead of *40 percent*.

(D) *Collectibles*. Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of business.

(E) *Nonqualified financial property*—(*1*) *In general*. Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to *nonqualified financial property*. For purposes of the preceding sentence, the term *nonqualified financial property* means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property except that such term does not include—

(*i*) Reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (because the definition of *nonqualified financial property* includes debt instruments with a term in excess of 18 months, banks, credit unions, and other financial institutions are generally excluded from the definition of a *qualified active low-income community business*); or

(*ii*) Debt instruments described in section 1221(a)(4).

(*2*) *Construction of real property*. For purposes of paragraph (d)(4)(i)(E)(*1*)(*i*) of this section, the proceeds of a capital or equity investment or loan by a CDE that will be expended for construction of real property within 12 months after the date the investment or loan is made are treated as a reasonable amount of working capital.

(ii) *Proprietorships*. Any business carried on by an individual as a proprietor is a qualified active low-income community business if the business would meet the requirements of paragraph (d)(4)(i) of this section if the business were incorporated.

(iii) *Portions of business*—(A) *In general*. A CDE may treat any trade or business (or portion thereof) as a qualified active low-income community business if the trade or business (or portion thereof) would meet the requirements of paragraph (d)(4)(i) of this section if the trade or business (or portion thereof) were separately incorporated and a complete and separate set of books and records is maintained for that trade or business (or portion thereof). However, the CDE's capital or equity investment or loan is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent the proceeds of the investment or loan are not used for the trade or business (or portion thereof) that is treated as a qualified active low-income community business under this paragraph (d)(4)(iii)(A).

(B) *Examples*. The following examples illustrate an application of paragraph (d)(4)(iii) of this section:

Example 1. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays $1 million for a capital interest in X. Z is a corporation that operates a supermarket that is not in a low-income community (as defined in section 45D(e)). X uses the proceeds of A's equity investment to make a loan to Z that Z will use to construct a new supermarket in a low-income community. Z will maintain a complete and separate set of books and records for the new supermarket. The proceeds of X's loan to Z will be used exclusively for the new supermarket. Assume that Z's new supermarket in the low-income community would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii)(A) of this section, X treats Z's new supermarket as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

Example 2. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays $1 million for a capital interest in X. Z is a corporation that operates a liquor store in a low-income community (as defined in section 45D(e)). A liquor store is not a qualified business under paragraph (d)(5)(iii)(B) of this section. X uses the proceeds of A's equity investment to make a loan to Z that Z will use to construct a restaurant next to the liquor store. Z will maintain a complete and separate set of books and records for the new restaurant. The proceeds of X's loan to Z will be used exclusively for the new restaurant. Assume that Z's restaurant would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii) of this section, X treats Z's restaurant as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

Example 3. X is a partnership and a CDE that receives a new markets tax credit allocation from the

Secretary. A pays $1 million for a capital interest in X. Z is a corporation that operates an insurance company in a low-income community (as defined in section 45D(e)). Five percent or more of the average of the aggregate unadjusted bases of Z's property is attributable to nonqualified financial property under paragraph (d)(4)(i)(E) of this section. Z's insurance operations include different operating units including a claims processing unit. X uses the proceeds of A's equity investment to make a loan to Z for use in Z's claims processing operations. Z will maintain a complete and separate set of books and records for the claims processing unit. The proceeds of X's loan to Z will be used exclusively for the claims processing unit. Assume that Z's claims processing unit would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii) of this section, X treats Z's claims processing unit as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

(iv) *Active conduct of a trade or business*—(A) *Special rule*. For purposes of paragraph (d)(4)(i) of this section, an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, engage in an activity that furthers its purpose as a nonprofit corporation) within 3 years after the date the investment or loan is made.

(B) *Example*. The application of paragraph (d)(4)(iv)(A) of this section is illustrated by the following example:

Example. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary on July 1, 2004. X makes a ten-year loan to Y. Y is a newly formed entity that will own and operate a shopping center to be constructed in a low-income community. Y has no revenues but X reasonably expects that Y will generate revenues beginning in December 2005. Under paragraph (d)(4)(iv)(A) of this section, Y is treated as engaged in the active conduct of a trade or business for purposes of paragraph (d)(4)(i) of this section.

(5) *Qualified business*—(i) *In general*. Except as otherwise provided in this paragraph (d)(5), the term *qualified business* means any trade or business. There is no requirement that employees of a qualified business be residents of a low-income community.

(ii) *Rental of real property*. The rental to others of real property located in any low-income community (as defined in section 45D(e)) is a *qualified business* if and only if the property is not residential rental property (as defined in section 168(e)(2)(A)) and there are *substantial improvements* located on the real property. For purposes of the preceding sentence, the term *substantial improvements* means improvements the cost basis of which equals or exceeds 50 percent of the cost basis of the land on which the improvements are located and the costs of which are incurred after the date the CDE makes the investment or loan. However, a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent any lessee of the real property is not a qualified business under this paragraph (d)(5).

(iii) *Exclusions*—(A) *Trades or businesses involving intangibles*. The term *qualified business* does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license.

(B) *Certain other trades or businesses*. The term *qualified business* does not include any trade or business consisting of the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(C) *Farming*. The term *qualified business* does not include any trade or business the principal activity of which is farming (within the meaning of section 2032A(e)(5)(A) or (B)) if, as of the close of the taxable year of the taxpayer conducting such trade or business, the sum of the aggregate unadjusted bases (or, if greater, the fair market value) of the assets owned by the taxpayer that are used in such a trade or business, and the aggregate value of the assets leased by the taxpayer that are used in such a trade or business, exceeds $500,000. For purposes of this paragraph (d)(5)(iii)(C), two or more trades or businesses will be treated as a single trade or business under rules similar to the rules of section 52(a) and (b).

(6) *Qualifications*—(i) *In general*. Except as provided in paragraph (d)(6)(ii) of this section, an entity is treated as a qualified active low-income community business for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section throughout the entire period of the investment or loan.

(ii) *Control*—(A) *In general*. If a CDE controls or obtains control of an entity at any time during the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), the entity will be treated as a qualified active low-income community business only if the entity satisfies the requirements of paragraph (d)(4)(i) of this section throughout the entire period the CDE controls the entity.

(B) *Definition of control*. Control means, with respect to an entity, direct or indirect ownership (based on value) or control (based on voting or management rights) of more than 50 percent of the entity. For purposes of the preceding sentence, the term *management rights* means the power to influence the management policies or investment decisions of the entity.

(C) *Disregard of control*. For purposes of paragraph (d)(6)(ii)(A) of this section, the acquisition of control of an entity by a CDE is disregarded during the 12-month period following such acquisition of control (the 12-month period) if—

(*1*) The CDE's capital or equity investment in, or loan to, the entity met the requirements of paragraph (d)(6)(i) of this section when initially made;

(*2*) The CDE's acquisition of control of the entity is due to financial difficulties of the entity that were unforeseen at the time the investment or loan described in paragraph (d)(6)(ii)(C)(*1*) of this section was made; and

(*3*) If the acquisition of control occurs before the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), either—

(*i*) The entity satisfies the requirements of paragraph (d)(4) of this section by the end of the 12-month period; or

(*ii*) The CDE sells or causes to be redeemed the entire amount of the investment or loan described in paragraph (d)(6)(ii)(C)(*1*) of this section and, by the end of the 12-month period, reinvests the amount received in respect of the sale or redemption in a qualified low-income community investment under paragraph (d)(1) of this section. For this purpose, the amount treated as continuously invested in a qualified low-income community investment is determined under paragraphs (d)(2)(i) and (ii) of this section.

(7) *Financial counseling and other services*. The term *financial counseling and other services* means advice provided by the CDE relating to the organization or operation of a trade or business.

(8) *Special rule for certain loans*—(i) *In general*. For purposes of paragraphs (d)(1)(i), (ii), and (iv) of this section, a loan is treated as made by a CDE to the extent the CDE purchases the loan from the originator (whether or not the originator is a CDE) within 30 days after the date the originator makes the loan if, at the time the loan is made, there is a legally enforceable written agreement between the originator and the CDE which—

(A) Requires the CDE to approve the making of the loan either directly or by imposing specific written loan underwriting criteria; and

(B) Requires the CDE to purchase the loan within 30 days after the date the loan is made.

(ii) *Example*. The application of paragraph (d)(8)(i) of this section is illustrated by the following example:

Example. (i) X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On October 1, 2004, Y enters into a legally enforceable written agreement with W. Y and W are corporations but only Y is a CDE. The agreement between Y and W provides that Y will purchase loans (or portions thereof) from W within 30 days after the date the loan is made by W, and that Y will approve the making of the loans.

(ii) On November 1, 2004, W makes a $825,000 loan to Z pursuant to the agreement between Y and W. Z is a qualified active low-income community business under paragraph (d)(4) of this section. On November 15, 2004, Y purchases the loan from W for $840,000. On December 31, 2004, X purchases the loan from Y for $850,000.

(iii) Under paragraph (d)(8)(i) of this section, the loan to Z is treated as made by Y. Y's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section. Accordingly, under paragraph (d)(1)(ii)(A) of this section, X's purchase of the loan from Y is a qualified low-income community investment in the amount of $850,000.

(e) *Recapture*—(1) *In general*. If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, then the tax imposed by Chapter 1 of the Internal Revenue Code for the taxable year in which the recapture event occurs is increased by the credit recapture amount under section 45D(g)(2). A recapture event under paragraph (e)(2) of this section requires recapture of credits allowed to the taxpayer who purchased the equity investment from the CDE at its original issue and to all subsequent holders of that investment.

(2) *Recapture event*. There is a recapture event with respect to an equity investment in a CDE if—

(i) The entity ceases to be a CDE;

(ii) The proceeds of the investment cease to be used in a manner that satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section; or

(iii) The investment is redeemed or otherwise cashed out by the CDE.

(3) *Redemption*—(i) *Equity investment in a C corporation*. For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is treated as a C corporation for Federal tax purposes is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment is treated as cashed out when section 301(c)(2) or section 301(c)(3) applies to amounts received by the equity holder. An equity investment is not treated as cashed out when only section 301(c)(1) applies to amounts received by the equity holder.

(ii) *Equity investment in an S corporation*. For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is an S corporation is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment in an S corporation is treated as cashed out when a distribution to a shareholder described in section 1368(a) exceeds the accumulated adjustments account determined under §1.1368–2 and any accumulated earnings and profits of the S corporation.

(iii) *Capital interest in a partnership*. In the case of an equity investment that is a capital interest in a CDE that is a partnership for Federal tax purposes, a *pro rata* cash distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year will not be treated as a redemption for purposes of paragraph (e)(2)(iii) of this section if the distribution does not exceed the CDE's *operating income* for the taxable year. In addition, a non-*pro rata de minimis* cash distribution by a CDE to a partner or partners during the taxable year will not be treated as a redemption. A non-*pro rata de minimis* cash distribution may not exceed the lesser of 5 percent of the CDE's *operating income* for that taxable year or 10 percent of the partner's capital interest in the CDE. For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, *operating income* is the sum of:

(A) The CDE's taxable income as determined under section 703, except that—

(*1*) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; and

(*2*) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;

(B) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;

(C) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k);

(D) Start-up expenditures amortized under section 195; and

(E) Organizational expenses amortized under section 709.

(4) *Bankruptcy*. Bankruptcy of a CDE is not a recapture event.

(5) *Waiver of requirement or extension of time*—(i) *In general*. The Commissioner may waive a requirement or extend a deadline if such waiver or extension does not materially frustrate the purposes of section 45D and this section.

(ii) *Manner for requesting a waiver or extension*. A CDE that believes it has good cause for a waiver or an extension may request relief from the Commissioner in a ruling request. The request should set forth all the relevant facts and include a detailed explanation describing the event or events relating to the request for a waiver or an extension. For further information on the application procedure for a ruling, see Rev. Proc. 2005–1, 2005–1 I.R.B. 1, or its successor revenue procedure (see §601.601(d)(2) of this chapter).

(iii) *Terms and conditions*. The granting of a waiver or an extension to a CDE under this section may require adjustments of the CDE's requirements under section 45D and this section as may be appropriate.

(6) *Cure period*. If a qualified equity investment fails the substantially-all requirement under paragraph (c)(5)(i) of this section, the failure is not a recapture event under paragraph (e)(2)(ii) of this section if the CDE corrects the failure within 6 months after the date the CDE becomes aware (or reasonably should have become aware) of the failure. Only one correction is permitted for each qualified equity investment during the 7-year credit period under this paragraph (e)(6).

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

Example. In 2003, A and B acquire separate qualified equity investments in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X uses the proceeds of A's qualified equity investment to make a qualified low-income community investment in Y, and X uses the proceeds of B's qualified equity investment to make a qualified low-income community investment in Z. Y and Z are not CDEs. X controls both Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. In 2003, Y and Z are qualified active low-income community businesses. In 2007, Y, but not Z, is a qualified active low-income community business and X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section. A's equity investment satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section using the direct-tracing calculation of paragraph (c)(5)(ii) of this section because A's equity investment is traceable to Y. However, B's equity investment fails the substantially-all requirement using the direct-tracing calculation because B's equity investment is traceable to Z. Therefore, under paragraph (e)(2)(ii) of this section, there is a recapture event for B's equity investment (but not A's equity investment).

(f) *Basis reduction*—(1) *In general*. A taxpayer's basis in a qualified equity investment is reduced by the amount of any new markets tax credit determined under paragraph (b)(1) of this section with respect to the investment. A basis reduction occurs on each credit allowance date under paragraph (b)(2) of this section. This paragraph (f) does not apply for purposes of sections 1202, 1400B, and 1400F.

(2) *Adjustment in basis of interest in partnership or S corporation*. The adjusted basis of either a partner's interest in a partnership, or stock in an S corporation, must be appropriately adjusted to take into account adjustments made under paragraph (f)(1) of this section in the basis of a qualified equity investment held by the partnership or S corporation (as the case may be).

(g) *Other rules*—(1) *Anti-abuse*. If a principal purpose of a transaction or a series of transactions is to achieve a result that is inconsistent with the purposes of section 45D and this section, the Commissioner may treat the transaction or series of transactions as causing a recapture event under paragraph (e)(2) of this section.

(2) *Reporting requirements*—(i) *Notification by CDE to taxpayer*—(A) *Allowance of new markets tax credit*. A CDE must provide notice to any taxpayer who acquires a qualified equity investment in the CDE at its original issue that the equity investment is a qualified equity investment entitling the taxpayer to claim the new markets tax credit. The notice must be provided by the CDE to the taxpayer no later than 60 days after the date the taxpayer makes the investment in the CDE. The notice must contain the amount paid to the CDE for the qualified equity investment at its original issue and the taxpayer identification number of the CDE.

(B) *Recapture event*. If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, the CDE must provide notice to each holder, including all prior holders, of the investment that a recapture event has occurred. The notice must be provided by the CDE no later than 60 days after the date the CDE becomes aware of the recapture event.

(ii) *CDE reporting requirements to Secretary*. Each CDE must comply with such reporting requirements to the Secretary as the Secretary may prescribe.

(iii) *Manner of claiming new markets tax credit*. A taxpayer may claim the new markets tax credit for each applicable taxable year by completing Form 8874, "*New Markets Credit*," and by filing Form 8874 with the taxpayer's Federal income tax return.

(iv) *Reporting recapture tax*. If there is a recapture event with respect to a taxpayer's equity investment in a CDE, the taxpayer must include the credit recapture amount under section 45D(g)(2) on the line for recapture taxes on the taxpayer's Federal income tax return for the taxable year in which the recapture event under paragraph (e)(2) of this section occurs (or on the line for total tax, if there is no such line for recapture taxes) and write *NMCR* (new markets credit recapture) next to the entry space.

(3) *Other Federal tax benefits*—(i) *In general*. Except as provided in paragraph (g)(3)(ii) of this section, the availability of Federal tax benefits does not limit the availability of the new markets tax credit. Federal tax benefits that do not limit the availability of the new markets tax credit include, for example:

(A) The rehabilitation credit under section 47;

(B) All deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k), and the expense deduction for certain depreciable property under section 179; and

(C) All tax benefits relating to certain designated areas such as empowerment zones and enterprise communities under sections 1391 through 1397D, the District of Columbia Enterprise Zone under sections 1400 through 1400B, renewal communities under sections 1400E through 1400J, and the New York Liberty Zone under section 1400L.

(ii) *Low-income housing credit*. If a CDE makes a capital or equity investment or a loan with respect to a qualified low-income building under section 42, the investment or loan is not a qualified low-income community investment under paragraph (d)(1) of this section to the extent the building's eligible basis under section 42(d) is financed by the proceeds of the investment or loan.

(4) *Bankruptcy of CDE*. The bankruptcy of a CDE does not preclude a taxpayer from continuing to claim the new markets tax credit on the remaining credit allowance dates under paragraph (b)(2) of this section.

(h) *Effective dates*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, this section applies on or after December 22, 2004, and may be applied by taxpayers before December 22, 2004. The provisions that apply before December 22, 2004, are contained in §1.45D–1T (see 26 CFR part 1 revised as of April 1, 2003, and April 1, 2004).

(2) *Exception for certain provisions*. Paragraph (d)(5)(ii) of this section as it relates to the definition of the term *substantial improvements* and the requirement that each lessee must be a qualified

business applies to qualified low-income community investments made on or after February 22, 2005.

§1.45D–1T [Removed]

Par. 3 Section 1.45D–1T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (b) is amended by removing the entry for "1.45D–1T" from the table.

Par. 6. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.45D–1	1545–1765
* * * * *	

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

Approved December 21, 2004.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 22, 2004, 12:38 p.m., and published in the issue of the Federal Register for December 28, 2004, 69 F.R. 77625)

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 817.—Treatment of Variable Contracts

26 CFR 1.817–5(f): Look-through rule for assets held through certain investment companies, partnerships, or trusts.

Segregated asset account. For purposes of determining whether a segregated asset account held by an insurance company is adequately diversified pursuant to section 817(h) of the Code, a segregated asset account that invests in a regulated investment company which in turn, holds an interest in another regulated investment company, may look through to the individual assets of both regulated investment companies.

Rev. Rul. 2005–7

ISSUE

For purposes of determining whether a segregated asset account is adequately diversified under section 817(h), how does the look-through rule of § 817(h)(4) of the Internal Revenue Code and § 1.817–5(f) of the Income Tax Regulations apply to an investment in a regulated investment company that, in turn, owns an interest in another regulated investment company?

FACTS

IC is a life insurance company subject to tax under § 801. In states where it is authorized to do so, IC offers variable life and variable annuity contracts (the "Contracts") that qualify as variable contracts under § 817(d). The assets that fund the Contracts are segregated from the assets that fund IC's traditional life insurance products. IC maintains a separate account for the assets funding the Contracts, and the income and liabilities associated with the separate account are maintained separately from IC's other accounts. The separate account is composed of several sub-accounts, one of which (the "Segregated Asset Account") is invested exclusively in Fund 1. No holder of a variable contract supported by the Segregated Asset Account possesses sufficient incidents of ownership over the assets of the account to be treated as the owner of those assets for federal income tax purposes. *See* Rev. Rul. 2003–91, 2003–2 C.B. 347.

Fund 1 is a regulated investment company within the meaning of § 851. Fund 1 owns shares in Fund 2, also a regulated investment company within the meaning of § 851, the value of which is greater than 55 percent of the value of the total assets of Fund 1. Except for Fund 1's investment in Fund 2 (and except as permitted by § 1.817–5(f)(3) of the Income Tax Regulations), all the beneficial interests in Fund 1 and Fund 2 are held by one or more segregated asset accounts of one or more insurance companies, and public access to the funds is available exclusively through the purchase of a variable contract. Pursuant to § 817(h)(1) and § 1.817–5(b) of the regulations, the investments of Fund 2 are adequately diversified. The investments of Fund 1 are likewise diversified, but only if, instead of treating its interest in Fund 2 as a single investment, Fund 1 is permitted to take into account a *pro rata* portion of each asset of Fund 2.

LAW AND ANALYSIS

Section 817(d) defines the term "variable contract" for purposes of part I of subchapter L of the Code (§§ 801–818). For a life insurance contract or an annuity contract to be a variable contract, it must provide for the allocation of all or a part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the issuing insurance company. In addition, for a life insurance contract to be a variable contract, it must qualify as a life insurance contract for federal income tax purposes, and the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account; for an annuity contract to be a variable contract, it must provide for the payment of annuities, and the amounts paid in, or the amount paid out, must reflect the investment return and the market value of the segregated asset account.

Section 817(h)(1) of the Code provides generally that a variable contract (other than a pension plan contract) that is otherwise described in § 817 and that is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and for any subsequent period) for which the investments made by such account are not adequately diversified.

Section 1.817–5(e) of the regulations provides that for purposes of section 817(h) of the Code a segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets.

Section 1.817–5(b) of the regulations sets forth the diversification requirements for variable contracts based on segregated asset accounts. Generally, the investments of a segregated asset account are considered to be adequately diversified for purposes of § 817(h) of the Code and § 1.817–5(b) of the regulations if no more than 55 percent of the value of the total assets of the account is represented by any one investment; no more than 70 percent by any two investments; no more than 80 percent by any three investments; and no more than 90 percent by any four investments.

Section 817(h)(4) and § 1.817–5(f) of the regulations provide a look-through rule for purposes of testing the diversification of a segregated asset account that invests in a regulated investment company, partnership, or trust. Section 1.817–5(f)(1) provides, in part, that if the look-through rule applies, a beneficial interest in an investment company shall not be treated as a single investment of a segregated asset account; instead, a *pro rata* portion of each asset of the investment company shall be treated, for purposes of § 1.817–5, as an asset of the segregated asset account.

Section 817–5(f)(2)(i) of the regulations provides that the look-through rule of § 1.817–5(f) shall apply to an investment company if (A) all the beneficial interests in the investment company (other than those described in § 1.817–5(f)(3)) are held by one or more segregated asset accounts of one or more insurance companies; and (B) public access to such investment company is available exclusively (except as otherwise permitted under § 1.817–5(f)(3)) through the purchase of a variable contract.

The beneficial interests described in § 1.817–5(f)(3) are interests that are held by (i) the general account of a life insurance company or a corporation related in a manner specified in § 267(b) of the Code to a life insurance company, but only if the return on those interests is computed in the same manner as the return on an interest held by a segregated asset account, there is no intent to sell the interests to the public, and a segregated asset account of the life insurance company also holds or will hold a beneficial interest in the investment company; (ii) the manager or a corporation related in a manner specified in § 267(b) to the manager of the investment company, provided similar requirements are met concerning the computation of return on the interests and intent to sell the interests to the public; (iii) the trustee of a qualified pension or retirement plan; or (iv) the public or policyholders that are treated as owners of beneficial interests in the investment company under Rev. Rul. 81–225, 1981–2 C.B. 12, but only if (A) the investment company was closed to the public in accordance with Rev. Rul. 82–55, 1982–1 C.B. 12; or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

Under the look-through rule of § 817(h)(4) and § 1.817–5(f), a *pro rata* portion of each asset of Fund 1 is treated as an asset of the Segregated Asset Account for purposes of determining whether the Segregated Asset Account is adequately diversified. Because the value of Fund 1's investment in Fund 2 is greater than 55 percent of the value of the total assets of Fund 1, however, the Segregated Asset Account is not adequately diversified unless its investment in Fund 1 is treated as including an investment in a *pro rata* portion of each of the assets of Fund 2.

In order for the look-through rule to apply to a beneficial interest in a regulated investment company, all the beneficial interests in the investment company must be held by one or more segregated asset accounts of one or more insurance companies (except as otherwise permitted pursuant to § 1.817–5(f)(3) of the regulations), and public access to the investment company must be available solely through the purchase of a variable contract. These two requirements are met with respect to both Fund 1 and Fund 2. Except as otherwise permitted under § 1.817–5(f)(3), all the beneficial interests in Fund 1 are held by segregated asset accounts that invested directly in Fund 1; all the beneficial interests in Fund 2 are held either by segregated asset accounts that invested directly in Fund 2, or by segregated asset accounts that invested directly in Fund 1 (and thus indirectly in Fund 2). Likewise, except as otherwise permitted under § 1.817–5(f)(3), public access to both Fund 1 and Fund 2 is available exclusively through the purchase of a variable contract funded by a segregated asset account that invests in Fund 1 or Fund 2. Accordingly, under the look-through rule of § 817(h), the Segregated Asset Account is treated as owning a *pro rata* portion of each asset of Fund 1, including a *pro rata* portion of each asset of Fund 2.

HOLDING

Under the facts set forth above, the look-through rule of § 817(h)(4) and § 1.817–5(f) of the regulations requires that the Segregated Asset Account be treated as owning a *pro rata* portion of each asset of Fund 1 and Fund 2 for purposes of satisfying the diversification requirements of § 817(h).

DRAFTING INFORMATION

The principal author of this revenue ruling is Thomas M. Preston of the Office of Chief Counsel Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Mr. Preston at (202) 622–3970 (not a toll-free call).

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for February 2005.

Rev. Rul. 2005–8

This revenue ruling provides various prescribed rates for federal income tax purposes for February 2005 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2005–8 TABLE 1

Applicable Federal Rates (AFR) for February 2005

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	2.92%	2.90%	2.89%	2.88%
110% AFR	3.22%	3.19%	3.18%	3.17%
120% AFR	3.51%	3.48%	3.46%	3.46%
130% AFR	3.81%	3.77%	3.75%	3.74%
Mid-Term				
AFR	3.83%	3.79%	3.77%	3.76%
110% AFR	4.21%	4.17%	4.15%	4.13%
120% AFR	4.60%	4.55%	4.52%	4.51%
130% AFR	4.99%	4.93%	4.90%	4.88%
150% AFR	5.77%	5.69%	5.65%	5.62%
175% AFR	6.74%	6.63%	6.58%	6.54%
Long-Term				
AFR	4.72%	4.67%	4.64%	4.63%
110% AFR	5.21%	5.14%	5.11%	5.09%
120% AFR	5.68%	5.60%	5.56%	5.54%
130% AFR	6.16%	6.07%	6.02%	5.99%

REV. RUL. 2005–8 TABLE 2

Adjusted AFR for February 2005

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.11%	2.10%	2.09%	2.09%
Mid-term adjusted AFR	2.89%	2.87%	2.86%	2.85%
Long-term adjusted AFR	4.20%	4.16%	4.14%	4.12%

REV. RUL. 2005–8 TABLE 3

Rates Under Section 382 for February 2005

Adjusted federal long-term rate for the current month	4.20%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.27%

REV. RUL. 2005–8 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for February 2005

Appropriate percentage for the 70% present value low-income housing credit	7.99%
Appropriate percentage for the 30% present value low-income housing credit	3.43%

REV. RUL. 2005–8 TABLE 5	
Rate Under Section 7520 for February 2005	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	4.60%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 2032.—Alternate Valuation

26 CFR 20.2032–1: Altenate valuation.

T.D. 9172

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 20 and 301

Gross Estate; Election to Value on Alternate Valuation Date

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that amend §20.2032–1(b) to reflect the change made to section 2032 of the Internal Revenue Code by the Deficit Reduction Act of 1984 and the technical change to that section made by the Tax Reform Act of 1986. In addition, the final regulations remove temporary regulation §301.9100–6T(b) of the Procedure and Administration Regulations so that estates that fail to make the alternate valuation election on the last estate tax return filed before the due date of the return, or on the first estate tax return filed after the due date of the return may request an extension of time to make the election under the provisions of §§301.9100–1 and 301.9100–3. The final regulations affect estates that are required to file Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*.

DATES: *Effective Date:* These regulations are effective on January 4, 2005.

Applicability Date: For dates of applicability, see §20.2032–1(h).

FOR FURTHER INFORMATION CONTACT: Theresa M. Melchiorre at (202) 622–7830 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 24, 2003, proposed regulations (REG–139845–02, 2004–5 I.R.B. 397) were published in the **Federal Register** [68 FR 74534]. The proposed regulations contained proposed amendments to the Estate Tax Regulations [26 CFR part 20] and the Procedure and Administration Regulations [26 CFR part 301] relating to the election under section 2032 to value a decedent's gross estate on the alternate valuation date. The proposed regulations reflected changes that were made to section 2032 by the Deficit Reduction Act of 1984, Public Law 98–369 (98 Stat. 494). Written comments were received on the proposed regulations, and a public hearing was held on June 3, 2004. The proposed regulations, with certain changes in response to the written and oral comments, are adopted as final regulations.

Summary of Comments and Explanation of Provisions

Determination of Eligibility to make the Alternate Valuation Election

The proposed regulations provided that the alternate valuation election may be made only if the election results in a decrease both in the value of the gross estate and in the sum of the estate tax and generation-skipping transfer tax liability (reduced by credits allowable against these taxes). One commentator noted that it may not be possible to determine whether the election will reduce the sum of estate tax and generation-skipping transfer tax if the generation-skipping transfer tax will not be imposed until a later time, as in the case of a later taxable termination or taxable distribution. In response to this comment, the final regulations provide that the determination of whether there has been a decrease in the sum of the estate tax and generation-skipping transfer tax liability (reduced by credits allowable against these taxes) is made with reference to the estate tax and generation-skipping transfer tax payable by reason of the decedent's death.

Availability of Relief under §§301.9100–1 and 301.9100–3

In view of the 1-year limitation imposed under section 2032(d)(2), the proposed regulations provided that no request for an extension of time to make the alternate valuation election under the provisions of §§301.9100–1 and 301.9100–3 will be granted if the request is submitted to the IRS more than 1 year after the due date of the return of tax imposed by section 2001 (including extensions of time actually granted). One commentator argued that the 1-year limitation in section 2032(d)(2) applies only to late-filed returns, and therefore should not limit the availability of relief under §§301.9100–1 and 301.9100–3 to make a late alternate valuation election if the taxpayer timely filed its return, but failed to make the election on the return. After considering the language and intent of section 2032 and §§301.9100–1 and 301.9100–3, the IRS and Treasury Department have determined that taxpayers may request relief under §§301.9100–1 and 301.9100–3, even after the expiration of the 1-year period, and that such relief may be granted (subject to the requirements of §§301.9100–1 and 301.9100–3) provided that the return of tax is filed no later than 1 year after the due date of the return (including extensions of time actually granted). This rule also will apply to requests under §§301.9100–1 and 301.9100–3 for an extension of time to make a protective election under section 2032.

The IRS and Treasury Department also have determined that taxpayers should be permitted to apply for relief under §§301.9100–1 and 301.9100–3 to make a late election under section 2056A to be treated as a Qualified Domestic Trust (QDOT). Like the alternate valuation election of section 2032, no election under section 2056A to be treated as a QDOT may be made on a return that is filed more than 1 year after the due date of the return (including extensions of time actually granted). Section 2056A(d). Thus, taxpayers will be permitted to apply for an extension of time under the provisions of §§301.9100–1 and 301.9100–3 to make an election under section 2056A(d), provided that the return of tax is filed no later than 1 year after the due date of the return (including extensions of time actually granted).

Any taxpayer eligible for relief under §§301.9100–1 and 301.9100–3 to make the section 2032 election or the 2056A(d) election is encouraged to file promptly an application for relief and a claim for refund before the statute of limitations under section 6511 expires in the event the requested relief is granted.

Special Analyses

It has been determined that this final Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation 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 Theresa Melchiorre of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 301 are amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. Section 20.2032–1(b) is revised and paragraph (h) is added to read as follows:

§20.2032–1 Alternate valuation.

* * * * *

(b) *Method and effect of election*—(1) *In general*. The election to use the alternate valuation method is made on the return of tax imposed by section 2001. For purposes of this paragraph (b), the term *return of tax imposed by section 2001* means the last estate tax return filed by the executor on or before the due date of the return (including extensions of time to file actually granted) or, if a timely return is not filed, the first estate tax return filed by the executor after the due date, provided the return is filed no later than 1 year after the due date (including extensions of time to file actually granted). Once the election is made, it is irrevocable, provided that an election may be revoked on a subsequent return filed on or before the due date of the return (including extensions of time to file actually granted). The election may be made only if it will decrease both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate. If the election is made, the alternate valuation method applies to all property included in the gross estate and cannot be applied to only a portion of the property.

(2) *Protective election*. If, based on the return of tax as filed, use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax liability payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate, a protective election may be made to use the alternate valuation method if it is subsequently determined that such a decrease would occur. A protective election is made on the return of tax imposed by section 2001. The protective election is irrevocable as of the due date of the return (including extensions of time actually granted). The protective election becomes effective on the date on which it is determined that use of the alternate valuation method would result in a decrease in both the value of the gross estate and in the sum (reduced by allowable credits) of the estate tax and generation-skipping transfer tax liability payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate.

(3) *Requests for extension of time to make the election*. A request for an extension of time to make the election or protective election pursuant to §§301.9100–1 and 301.9100–3 of this chapter will not be granted unless the return of tax imposed by section 2001 is filed no later than 1 year after the due date of the return (including extensions of time actually granted).

* * * * *

(h) *Effective date*. Paragraph (b) of this section is applicable to decedents dying on or after January 4, 2005. However, pursuant to section 7805(b)(7), taxpayers may elect to apply paragraph (b) of this section retroactively if the period of limitations for filing a claim for a credit or refund of Federal estate or generation-skipping transfer tax under section 6511 has not expired.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

§301.9100–6T [Amended]

Par. 4. Section 301.9100–6T is amended by:

1. Removing the language "paragraph (b)(2)" from paragraph (a)(2) introductory

text, and adding the language "paragraph (a)(2)" in its place.

2. Removing paragraph (b).

3. Redesignating paragraphs (c) through (s) as paragraphs (b) through (r), respectively.

4. Removing the language "paragraph (c)(2)" from the last sentence in newly designated paragraph (b)(2) and adding the language "paragraph (b)(2)" in its place.

5. Removing the language "paragraph (l)" from the second, fourth and last sentences in newly designated paragraph (k) and adding the language "paragraph (k)" in its place.

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

Approved December 28, 2004.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 3, 2005, 8:45 a.m., and published in the issue of the Federal Register for January 4, 2005, 70 F.R. 295)

Section 2056A.—Qualified Domestic Trust

The preamble of the final regulations under section 2032 of the Code describes a change in the position of the IRS on the availability of relief to make the section 2056A(d) election under sections 301.9100–1 and 301.9100–3 of the regulations. See T.D. 9172, page 468.

Section 6658.—Coordination With Title 11

26 CFR 301.6651–1: Failure to file tax return or to pay tax.
(Also §§ 6654, 6655.)

Bankruptcy cases; definition of "pending". This ruling discusses the definition of "pending" regarding bankruptcy cases for purposes of the relief from the imposition of certain penalties provided under section 6658 of the Code.

Rev. Rul. 2005–9

ISSUE

When is a bankruptcy case no longer "pending" for purposes of the relief from the imposition of certain penalties provided under section 6658 of the Internal Revenue Code for the period during which a bankruptcy case is pending?

FACTS

In *Situations A*, *B*, and *C* described below: (1) an individual taxpayer files a bankruptcy petition under Chapter 7 or Chapter 11 of title 11 of the U.S. Code ("the Bankruptcy Code") and has an income tax liability for a taxable year that ended prior to the filing of the bankruptcy petition; (2) the prepetition tax liability is excepted from discharge under section 523(a)(1)(A) of the Bankruptcy Code; (3) the tax liability is reported on a timely filed tax return, but is not paid in full; and (4) the failure to pay penalty under section 6651(a)(2) may be imposed except to the extent of the relief provided by section 6658 of the Internal Revenue Code for the period during which the bankruptcy case is pending.

Situation A. The taxpayer files a Chapter 7 bankruptcy petition on Date 1. The court enters an order granting the debtor a discharge on Date 2, which is six weeks after Date 1. Distributions from the bankruptcy estate are made and the Service receives partial payment of income taxes on Date 3, one year after Date 1. The court discharges the trustee and closes the case on Date 4, which is 30 days after receiving the trustee's final report.

Situation B. The taxpayer files a Chapter 11 bankruptcy petition on Date 1. The plan is confirmed and the taxpayer receives a discharge on Date 2. Payments to the Service commence on Date 3. The court closes the case on Date 4, which is 30 days after Date 3. Payments under the plan are required to be made for several years after Date 4.

Situation C. The facts are the same as in *Situation B*, except that the court does not close the case on Date 4. Beginning approximately one year after Date 3, the taxpayer fails to make payments as required under the plan. Shortly after the default, the Service files a motion to dismiss the case and the court enters a dismissal order on Date 5.

LAW AND ANALYSIS

Section 6658(a) provides, in part, that "[n]o addition to the tax shall be made under section 6651, 6654, or 6655 for failure to make timely payment of tax with respect to a period during which a case is pending under title 11 of the United States Code . . . ." Section 6658 applies to tax arising before the taxpayer files a bankruptcy petition if (1) the petition was filed before the due date of the return or (2) the date for making the addition to the tax occurs on or after the day on which the petition was filed. Section 6651 imposes penalties for failure to file a return or pay a tax, and sections 6654 and 6655 impose penalties for failure to pay estimated taxes. The term "pending" is not defined in section 6658.

A bankruptcy case is commenced by filing a petition with the bankruptcy court pursuant to sections 301 through 304 of the Bankruptcy Code. A case is "pending" for purposes of section 6658 after the debtor files a petition with the bankruptcy court. A bankruptcy case is no longer pending for purposes of section 6658 when it is closed or dismissed. *See Carey v. Saffold*, 536 U.S. 214, 219–220 (2002) (consulting Webster's Third International Dictionary for the ordinary meaning of the word "pending," the Court determined that a state court application for collateral review remains pending "until the application has achieved final resolution").

Section 350 of the Bankruptcy Code requires the court to close a case once the estate is fully administered and the court has discharged the trustee. Bankruptcy Rule 5009 provides that in Chapter 7 cases, there is a presumption that the estate has been fully administered and the case may be closed if (1) the trustee has filed a final report and final account and has certified that the estate has been fully administered, and (2) within 30 days after the trustee's filing and certification, no objection has been filed by the United States trustee or a party in interest.

Bankruptcy Rule 3022 provides that the court shall enter a final decree closing a Chapter 11 case after an estate is fully administered. The Advisory Committee Notes to the 1991 amendments to Bankruptcy Rule 3022 provide that the final decree closing the case should not be delayed solely because payments required by the plan have not been completed. Fed. R. Bankr. P. 3022 advisory committee notes.

Whether a case has been fully administered and should be closed presents a different question under Chapter 7 than under Chapter 11. Although a Chapter 7 case is not fully administered and generally is not closed until after final distribution of the property of the estate, a Chapter 11 case may be considered fully administered and may be closed shortly after payments commence under the plan even though the debtor will continue to make payments. However, in both Chapters 7 and 11, the closing of the case marks the end of the bankruptcy court's administration of the estate and is, therefore, the proper date on which a case is no longer pending for purposes of section 6658.

Similarly, the dismissal of a bankruptcy case terminates the case and the bankruptcy court's administration of the bankruptcy estate. The legislative history to section 349 of the Bankruptcy Code, which sets forth the effect of a dismissal of a bankruptcy case, provides that the purpose of section 349 is "to undo the bankruptcy case, as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case." S. Rep. No. 989, 95th Cong., 2d Sess. 48 (1978).

In *Situation A*, the case is pending under section 6658 until the court closes the case on Date 4. The entry of the discharge order on Date 2 does not terminate the relief provided by section 6658 because the estate has not been fully administered.

In *Situation B*, the confirmation of the plan on Date 2 discharges the debtor from all pre-confirmation dischargeable debts. The confirmation of the plan does not terminate the administration of the estate. Under section 350 and Bankruptcy Rule 3022, the estate is not fully administered until it is closed on Date 4. As of Date 4, the administration of the estate is complete and the case is no longer pending even though the debtor is required to make payments under the plan for several years. Thus, the penalty relief provided by section 6658 ceases as of Date 4.

In *Situation C*, the bankruptcy court does not close the case 30 days after confirmation of the plan as in *Situation B*, but keeps the case open while the debtor complies with the terms of the plan. However, one year after confirmation, the debtor fails to make the payments required by the terms of the plan. The default does not terminate the case or end the court's involvement in the administration of the estate. The order dismissing the case terminates the administration of the estate. The prohibition against imposition of the penalty ends on Date 5, the date on which the dismissal order is entered.

Although *Situations A*, *B*, and *C* describe bankruptcy cases filed under Chapters 7 and 11 of the Bankruptcy Code, the treatment of a case as no longer pending when the case is closed or dismissed as set forth in this ruling also applies to bankruptcy cases filed under Chapters 12 and 13 of the Bankruptcy Code.

HOLDING

A bankruptcy case is no longer pending for purposes of relief under section 6658 when the bankruptcy case is closed or dismissed.

DRAFTING INFORMATION

The principal author of this revenue ruling is the Collection, Bankruptcy & Summonses Division, Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this revenue ruling, contact Delores Dillmann at (202) 622–3620 (not a toll-free call).

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Section 7702.—Life Insurance Contract Defined

(Also § 7702A.)

Life insurance contracts. For purposes of determining whether a contract qualifies as a life insurance contract under section 7702 of the Code, and as a modified endowment contract under section 7702A, charges for qualified additional benefits (QABs) are to be taken into account under the expense charge rule of section 7702(c)(3)(B)(ii) rather than under the mortality charge rule of section 7702(c)(3)(B)(i). Issuers whose compliance systems do not currently account for QABs under the expense charge rule of section 7702(c)(3)(B)(ii) are provided alternatives to correct their compliance systems.

Rev. Rul. 2005–6

ISSUE

For purposes of determining whether a contract qualifies as a life insurance contract under § 7702 of the Internal Revenue Code and as a modified endowment contract under § 7702A, should charges for qualified additional benefits (QABs) be taken into account under the mortality charge rule of § 7702(c)(3)(B)(i) or the expense charge rule of § 7702(c)(3)(B)(ii)?

FACTS

IC is a life insurance company organized and licensed to do business in State. In Year, IC issued a Policy in State with a Rider that provides term life insurance coverage on the life of a family member of the individual insured by the Policy. The Policy is a life insurance contract under the law of State and was designed to qualify as a life insurance contract under § 7702 by meeting the guideline premium requirements of § 7702(c) and falling within the cash value corridor of § 7702(d). IC imposes a charge for the mortality risk that it assumed pursuant to the Rider and subtracts this charge monthly from the Policy's cash value.

LAW AND ANALYSIS

Section 7702(a) provides that, for a contract to qualify as a life insurance contract for Federal income tax purposes, the contract must be a life insurance contract under the applicable law and must either (1) satisfy the cash value accumulation test of § 7702(b), or (2) both meet the guideline premium requirements of § 7702(c) and fall within the cash value corridor of § 7702(d).

A contract meets the guideline premium requirements of § 7702(c) if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation as of that time. The guideline premium limitation as of any date is the greater of (A) the guideline single premium, or (B) the sum of the guideline level premiums to that date. The guideline single premium is the premium that would be required on the date the contract is issued to fund the future benefits under the contract, based on the following three elements enumerated in section 7702(c)(3)(B):

(i) reasonable mortality charges that meet the requirements (if any) prescribed in regulations and that (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued;

(ii) any reasonable charges (other than mortality charges) that (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid; and

(iii) interest at the greater of an annual effective rate of six percent or the rate or rates guaranteed on issuance of the contract.

The guideline level premium is the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis but using a minimum interest rate of four percent, rather than six percent.

A contract meets the cash value accumulation test of § 7702(b) if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. This determination is made, in part, on the basis of the mortality charge rule of § 7702(c)(3)(B)(i) and, in the case of QABs, the expense charge rule of § 7702(c)(3)(B)(ii).

Section 7702(f)(4) defines the term "future benefits" to mean death benefits and endowment benefits. Section 7702(f)(5)(A)(iii) characterizes family term riders as QABs. Section 7702(f)(5)(B) provides that QABs are not treated as future benefits under the contract, but the charges for such benefits are treated as future benefits. Accordingly, charges for the Rider should be accounted for as future benefits under the Policy.

Under the mortality charge rule of § 7702(c)(3)(b)(i), reasonable mortality charges are taken into account if they meet the requirements (if any) prescribed in regulations and do not exceed the mortality charges specified in the prevailing commissioners' standard tables as of the time the contract is issued. There is no requirement that the charges taken into account be charges that are expected to be paid. In contrast, under the expense charge rule of § 7702(c)(3)(B)(ii), reasonable charges other than mortality charges are taken into account only if they are reasonably expected to be actually paid. For this reason, accounting for charges for the Rider under the mortality charge rule, rather than the expense charge rule, would in some cases produce a higher net single premium and higher guideline level premiums for purposes of testing a contract's compliance with § 7702.

Section 7702A defines a modified endowment contract (MEC) generally as a contract that meets the requirement of § 7702 but fails to meet the 7-pay test set forth in § 7702A(b) (or that is received in exchange for a contract that is otherwise a MEC). Under § 7702A(b), a contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before that time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. For this purpose, § 7702A(c)(1) provides that determinations under the 7-pay test are made by applying the cash value accumulation test rules of § 7702(b)(2). Under that provision, charges for QABs are accounted for under the expense charge rule of § 7702(c)(3)(B)(ii).

Section 7702 is silent on the treatment of charges for QABs for purposes of determining whether a contract satisfies the guideline premium requirements. Under § 7702(b)(2)(B), however, charges for QABs are subject to the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of determining whether a contract satisfies the cash value accumulation test. The same rule applies under § 7702A(c)(1) for purposes of determining whether a contract satisfies the 7-pay test and therefore is not a MEC. There is no indication that Congress intended charges for QABs to be accounted for under one rule for purposes of the cash value accumulation test of § 7702(b) and the 7-pay test of § 7702A(b), and under a different rule for purposes of the guideline premium requirements of § 7702(c). Moreover, there is no indication that Congress intended to take into account charges with respect to QABs that exceed amounts reasonably expected to be actually paid. Accordingly, charges taken into account with respect to QABs are subject to the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of the guideline premium requirements.

HOLDING

Charges for QABs should be taken into account under the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of determining whether a contract qualifies as a life insurance contract under § 7702 or as a MEC under § 7702A.

EFFECTIVE DATE

This revenue ruling is effective February 7, 2005.

APPLICATION

The following alternatives are available to issuers whose compliance systems do not currently account for charges for QABs under the expense charge rule of § 7702(c)(3)(B)(ii):

A. If an issuer's compliance system does not properly account for charges for QABs but no contracts have failed to satisfy the requirements of § 7702(a) as a result of the system's deficiency, the issuer may correct its compliance system to account for those charges using the expense charge rule without contacting the Service.

B. If an issuer's compliance system does not properly account for charges for QABs and, as a result, some life insurance contracts do not meet the definition of life insurance contract under § 7702(a), the issuer may request a closing agreement on or before February 7, 2006, under the procedures set forth in Rev. Proc. 2005–1, 2005–1 I.R.B. 1. In addition to the modifications to the ruling process provided by Rev. Proc. 2001–42, 2001–2 C.B. 212 (concerning inadvertent MECs), and Rev. Rul. 91–17, 1991–1 C.B. 190, as supplemented by Notice 99–48, 1999–2 C.B. 429 (concerning failures under § 7702(a)), the following modifications will apply to a closing agreement requested under this revenue ruling:

1. the issuer must identify all contracts administered under the compliance system, but need not identify which contracts fail to meet the requirements of § 7702(a) or are inadvertent MECs under § 7702A;
2. the contracts identified in the closing agreement will not be treated as fail-

ing the requirements of § 7702(a) or as MECs under § 7702A by reason of improperly accounting for charges for existing QABs, including future charges resulting from an increase in an existing QAB or the addition of a new QAB pursuant to the exercise of a right that existed in the contract before April 8, 2005; relief under the closing agreement will not extend to improper accounting for charges for an increase in an existing QAB or the addition of a new QAB that are not pursuant to the exercise of a right that existed in the contract before that date;

3. no corrective action need be taken with respect to the compliance system or with respect to contracts identified in the closing agreement;
4. in lieu of an amount based on the tax and interest that would have been owed by the policyholders if they were treated as receiving the income on the contract, the amount due under the closing agreement will be based on the aggregate number of contracts for which relief is requested, as set forth in the following schedule:

Number of Contracts	Amount due
20 or fewer	$1,500.00
21 to 50	$2,000.00
51 to 100	$5,000.00
101 to 500	$10,000.00
501 to 1,000	$16,000.00
1,001 to 5,000	$30,000.00
5,001 to 10,000	$40,000.00
Over 10,000	$50,000.00

5. the request for a closing agreement must be submitted to the appropriate address and with the appropriate user fee set forth in Rev. Proc. 2005–1; in addition, the closing agreement should reflect the following address for mailing the closing agreement and amount due, after the closing agreement has been executed by the Service: Internal Revenue Service, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

C. After February 7, 2006, an issuer whose compliance system does not properly account for charges for QABs may request a closing agreement under the terms and conditions set forth above, except that (1) the closing agreement must identify the contracts that fail to meet the requirements of § 7702(a) or are inadvertent MECs under § 7702A; and (2) the closing agreement must require the issuer to correct its compliance system and to bring the identified contracts into compliance with § 7702(a) or § 7702A, as appropriate.

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Melissa S. Luxner at (202) 622–3970 (not a toll-free call).

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2005. See Rev. Rul. 2005-8, page 466.

Part III. Administrative, Procedural, and Miscellaneous

Domestic Reinvestment Plans and Other Guidance Under Section 965

Notice 2005–10

SECTION 1. OVERVIEW

This notice provides guidance concerning new section 965 of the Internal Revenue Code (Code). It sets forth general principles and specific guidance on domestic reinvestment plans and on investments in the United States described in section 965(b)(4)(B). The Treasury Department and the Internal Revenue Service (IRS) intend to issue additional notices providing guidance concerning section 965, including rules relating to the foreign tax credit and expense allocation, rules for adjusting the calculation of the base period amounts to take into account mergers, acquisitions and spin-offs, and rules regarding controlled groups. The Treasury Department and the IRS expect to issue regulations that incorporate the guidance provided in this and the subsequent notices.

The remainder of this notice is divided into eleven sections. Section 2 provides background information with respect to section 965. Section 3 addresses the meaning of the term "cash dividends." Section 4 sets forth general guidance concerning domestic reinvestment plans. Section 5 lists certain expenditures that, if made pursuant to a domestic reinvestment plan, are investments in the United States described in section 965(b)(4)(B) (permitted investments). Section 6 lists certain expenditures that are not permitted investments. Section 7 describes how a taxpayer elects to apply section 965 to a taxable year. Section 8 provides guidance on reporting requirements and on how a taxpayer may, under the facts and circumstances, establish to the satisfaction of the Commissioner that the dividend proceeds are invested in the United States pursuant to a domestic reinvestment plan, including a safe harbor for making such a demonstration. Section 9 provides transition rules that apply to certain taxpayers that, prior to the issuance of this notice, either adopted a domestic reinvestment plan and received a dividend, or filed a tax return for a taxable year to which section 965 applies. Section 10 provides the effective date of this notice. Section 11 provides information required under the Paperwork Reduction Act of 1995. Finally, section 12 provides drafting information.

This notice provides guidance on several of the requirements for eligibility for the deduction provided under section 965(a). Section 965 contains additional requirements, which are briefly outlined in section 2 of this notice but which are not addressed in detail in this notice, that must be satisfied in order for a cash dividend to be eligible for the deduction provided under section 965(a).

SECTION 2. BACKGROUND

The American Jobs Creation Act of 2004 (P.L. 108–357) (the Act), enacted on October 22, 2004, added new section 965 to the Code. In general, and subject to limitations discussed below, section 965(a) provides that a corporation that is a U.S. shareholder[1] of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent dividends received deduction (DRD) with respect to certain cash dividends it receives from its CFCs. For this purpose, all U.S. shareholders that are members of an affiliated group filing a consolidated return under section 1501 are treated as one U.S. shareholder. Section 965(c)(5).

For purposes of section 965, the term "dividends" includes cash amounts included in gross income as dividends under sections 302 and 304, but does not include amounts treated as dividends under section 78 or 1248 or, in certain cases, section 367.[2] H.R. Conf. Rep. No. 108–755, at 314–15. For this purpose a cash dividend also includes a cash distribution from a CFC that is excluded from gross income under section 959(a) to the extent of inclusions under section 951(a)(1)(A) as a result of a cash dividend during the election year to: (1) such CFC from another CFC in a section 958(a) chain of ownership; or (2) any other CFC in such chain of ownership to the extent of cash distributions described in section 959(b) made during such year to the CFC from which such U.S. shareholder received such distribution.

The DRD under section 965(a) is subject to several limitations. First, section 965(b)(1) limits the amount of dividends eligible for the deduction to the greatest of the following three amounts: (1) $500 million; (2) the amount shown on the taxpayer's applicable financial statement[3] as earnings permanently reinvested outside the United States; or (3) in the case of an applicable financial statement that does not show a specific amount of earnings permanently reinvested outside the United States and that shows a specific amount of tax liability attributable to such earnings, the amount of such liability divided by 0.35.

Second, section 965(b)(2) limits the amount of dividends eligible for the deduction to the excess (if any) of the dividends received during the taxable year by the U.S. shareholder from CFCs over the annual average for the base period years of: (1) the dividends received during each base period year by such shareholder from CFCs; (2) the amounts includible in such shareholder's gross income for each base period year under section 951(a)(1)(B) with respect to CFCs; and (3) the amounts that would have been included for each base period year but for section 959(a) with respect to CFCs. The base period years are the three taxable years which are among the five most recent taxable

[1] The term U.S. shareholder means, with respect to any foreign corporation, a U.S. person who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Section 951(b).

[2] Dividends resulting from liquidations qualifying under section 332 to which section 367(b) applies qualify as cash dividends to the extent the U.S. shareholder receives cash as part of the liquidation. Section 965(c)(3). A deemed liquidation effectuated through an election under §301.7701–3(c), however, does not result in an actual distribution of cash as required under section 965. See H.R. Conf. Rep. No. 108–755, at 315, footnote 108.

[3] The term "applicable financial statement" means the most recently audited financial statement which is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, which is used for the purposes of a statement or report to creditors or shareholders or for any other substantial nontax purpose, and, if the taxpayer is required to file with the SEC, is so filed on or before June 30, 2003. Section 965(c)(1).

years ending on or before June 30, 2003, determined by disregarding the year for which such total amount is highest and the year for which such total amount is lowest among such five years. Section 965(c)(2).

Third, section 965(b)(3) provides that the amount of dividends eligible for the deduction is reduced by any increase in related-party indebtedness of the CFC between October 3, 2004, and the close of the election year. For this purpose, all CFCs with respect to which the taxpayer is a U.S. shareholder are treated as a single CFC.

Finally, section 965(b)(4) provides that the amount of the dividend must be invested in the United States pursuant to a domestic reinvestment plan that is approved by the taxpayer's president, chief executive officer, or comparable official before the payment of the dividend, and that is subsequently approved by the taxpayer's board of directors, management committee, executive committee, or similar body. The domestic reinvestment plan must provide for the investment of the dividend in the United States (other than as a payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation. This list is not intended to be exclusive. H.R. Conf. Rep. No. 108–755, at 316.

Section 965(c) provides definitions and special rules, including rules for adjusting the calculation of the base period amounts to take into account mergers, acquisitions and spin-offs. Sections 965(d) and (e) provide special rules limiting foreign tax credits and expense deductions and limiting the attributes available to offset the nondeductible portion of dividends, respectively.

Section 965(f) provides that taxpayers may elect the application of section 965 for either the taxpayer's last taxable year which begins before October 22, 2004, or the taxpayer's first taxable year which begins during the one-year period beginning on October 22, 2004.

SECTION 3. CASH DIVIDENDS

.01 *In General*

The DRD under section 965(a) applies only to cash dividends[4] received by a corporate U.S. shareholder from CFCs with respect to which it is a U.S. shareholder. For this purpose, the term "cash" includes both U.S. dollars and foreign currency. A CFC may effect distributions of cash by wire transfer or check.

The Treasury Department and the IRS anticipate that, in some cases, a CFC will liquidate investments in cash equivalents in order to pay a cash dividend as required under section 965. It is also anticipated that the U.S. shareholder that receives such a cash dividend from the CFC may temporarily invest all or a portion of the dividend proceeds in cash equivalents, which may be similar in nature to those that had been held by the CFC. For purposes of section 965, the mere fact that the CFC held cash equivalents prior to the payment of a cash dividend and the U.S. shareholder holds cash equivalents after the payment of such dividend will not itself cause the Commissioner to recharacterize the dividend as a distribution by the CFC of the cash equivalents (rather than as a required distribution of cash), under the step transaction doctrine, or other similar authorities. For purposes of this paragraph, the term "cash equivalents" has the meaning provided in §1.897–7T(a).

.02 *Treatment of Distributions to Intermediary Pass-Through Entities*

To qualify as a cash dividend within the meaning of section 965, cash must be distributed from a CFC to the U.S. shareholder in the taxable year for which an election under section 965 applies. For purposes of section 965(a), a cash dividend paid by a CFC to a pass-through entity (a partnership or disregarded entity) that is owned by a U.S. shareholder shall be treated as received by such U.S. shareholder only if and to the extent that such shareholder receives cash in the amount of the CFC dividend during the taxable year for which such election is in effect. In addition, in the case of a partnership, a cash dividend is treated as received by a U.S. shareholder that is a partner in such partnership only if the amount of the dividend is: (i) allocated to the U.S. shareholder-partner under the rules of sections 702 and 704 and the regulations thereunder; and (ii) separately stated to the partner under §1.702–1(a)(8)(ii).

For example, if a U.S. shareholder owns a disregarded entity that, in turn, owns a CFC that pays a cash dividend to the disregarded entity, such dividend will qualify as a cash dividend received by the U.S. shareholder within the meaning of section 965 only to the extent the disregarded entity distributes cash in the amount of the dividend proceeds to the U.S. shareholder during the taxable year to which an election under section 965 applies. A loan of cash from the disregarded entity to the U.S. shareholder would not be considered a distribution of cash for this purpose because, even though the loan would not otherwise be regarded for tax purposes, there would be a legal obligation for the U.S. shareholder to repay the cash to the disregarded entity.

.03 *Amount of Cash Dividend Not Reduced by Related Deductions or Expenses*

The amount otherwise qualifying as a cash dividend is not reduced by expenses or deductions of the taxpayer related to such cash dividend, including any foreign withholding tax and U.S. federal, state or local income tax imposed thereon. Taxpayers must invest the gross amount of the dividend (not reduced by expenses or deductions related to such dividend) in order for the total cash dividend to qualify under section 965(b)(4). Thus, for example, if a CFC distributes $100x of cash to its U.S. shareholder with respect to its stock that is treated as a dividend, and such distribution is subject to a foreign withholding tax of $5x (such that the U.S. shareholder receives a net amount of $95x), the amount of the cash dividend is $100x. Accordingly, the taxpayer must invest $100x in the United States pursuant to a domestic reinvestment plan in order for the $100x cash dividend to satisfy the requirements of section 965(b)(4).

.04 *Interaction with Section 959*

Except as provided in section 965(a)(2), the term "dividends" does not include

[4] For purposes of section 965, a cash dividend includes cash amounts treated as a dividend pursuant to section 356(a)(2).

amounts that are not included in gross income pursuant to section 959(a). In other words, distributions by a CFC to its U.S. shareholder with respect to its stock out of its earnings and profits described in section 959(c)(1) and (c)(2) do not qualify as dividends (except to the extent provided in section 965(a)(2)). Thus, for example, if a CFC has earnings and profits described in section 959(c)(1) of 100u and earnings and profits described in section 959(c)(3) of 50u, under the ordering rules of section 959(c) the CFC must distribute 150u to its U.S. shareholder with respect to its stock in order to be considered to have paid a 50u dividend within the meaning of section 965.

SECTION 4. DOMESTIC REINVESTMENT PLANS

.01 *In General*

A domestic reinvestment plan is a written plan prepared by the taxpayer that describes the planned investment in the United States of the amount of the dividend otherwise qualifying for the deduction under section 965(a) in reasonable detail and specificity. It may encompass more than one cash dividend from one or more CFCs. A taxpayer may adopt separate domestic reinvestment plans to apply to different cash dividends made during the taxable year to which it elects to apply section 965. Under section 965, amounts invested in the United States pursuant to the domestic reinvestment plan are not required to exceed investments made in prior years or investments that were planned by the taxpayer prior to the enactment of section 965.

.02 *Procedural Requirements*

Pursuant to section 965(b)(4)(A), a domestic reinvestment plan must be approved by the taxpayer's president, chief executive officer, or an official exercising comparable authority over the taxpayer before the cash dividend to which it relates is paid. The taxpayer's board of directors, management committee, executive committee, or the body which exercises similar authority over the taxpayer must subsequently approve the domestic reinvestment plan. Such approval may be granted after the payment of the dividend subject to the domestic reinvestment plan, and no special meeting of the board or other body is required to grant this approval. Where the U.S. shareholder of a CFC is a member of a consolidated group within the meaning of §1.1502–1(h), the domestic reinvestment plan must be approved by the president, chief executive officer, or comparable official, and by the board of directors, management committee, executive committee, or similar body, of the common parent of the consolidated group. In such a case, the domestic reinvestment plan need not be separately approved by other members of the consolidated group, even if such members make permitted investments pursuant to such plan.

.03 *Specificity*

The domestic reinvestment plan must describe specific anticipated investments in the United States. The Treasury Department and the IRS do not intend to provide a template for a domestic reinvestment plan. The composition of a taxpayer's domestic reinvestment plan may vary depending on the type of permitted investments contemplated by the plan (for example, research and development or capital improvements to plant and facility), the time period over which permitted investments will be made, and whether factors beyond the taxpayer's control could affect its ability to make the contemplated investment. These and other relevant facts and circumstances should be taken into account in applying the reasonable specificity standard set forth in this notice.

In general, the domestic reinvestment plan must provide sufficient detail to enable the taxpayer to demonstrate upon examination that the expenditures that subsequently occur were of the kind that were in fact contemplated at the time of the adoption of such plan. Thus, a domestic reinvestment plan that merely recites the statutory language without further detail, or that merely refers generically to expenditures on whatever uses may be permitted for purposes of section 965, will not be considered to have met the statutory requirements.

The domestic reinvestment plan need not indicate precise dollar amounts expected to be incurred for each specific component of an investment, but must state the total dollar amount that will be invested for each respective principal investment in the United States pursuant to such plan (*e.g.*, a total dollar amount for expenditures for research and development on product lines A, B and C and a total dollar amount for expenditures for advertising for brands D and E). A taxpayer may shift expenditures between investments specified in the plan without amending the plan and, to that extent, the additional amounts spent on one investment would be considered an alternative investment (as described below). For example, if a $100x dividend reinvestment plan calls for expenditures of $30x on research and development and $70x on advertising, and the taxpayer in fact expends $90x on the advertising, the additional $20x expenditures on advertising is an alternative investment.

The domestic reinvestment plan must state a reasonable time period, taking into account the nature of the investments to be made in the United States and other facts and circumstances, during which the taxpayer anticipates completing all such investments pursuant to such plan.

The Treasury Department and the IRS recognize that, after a domestic reinvestment plan is approved, certain investments specified in such plan may no longer be practicable or desirable for various reasons. This may occur, for example, if an investment is dependent on actions of other persons, or upon reasonably anticipated business conditions that subsequently change. For example, a taxpayer's domestic reinvestment plan may contemplate as a principal investment a plant in the United States the construction of which cannot proceed absent certain governmental approvals and, subsequent to the adoption of the plan, the necessary governmental approvals are denied. Accordingly, the domestic reinvestment plan may provide alternative investments, which are themselves permitted investments, for investing the amount of the dividend in the United States in cases where principal investments are subsequently delayed or rejected. Such alternative investments must be described in the domestic reinvestment plan under the same standard of specificity provided above. The domestic reinvestment plan need not, however, set forth the conditions under which the alternative investments will be substituted for the principal investments.

.04 *Amending the Domestic Reinvestment Plan*

In general, the taxpayer is not permitted to modify or amend a domestic reinvestment plan after payment of the dividend to which such plan relates. See section 9.02 of this notice for a special transition rule in the case of certain dividends paid prior to January 13, 2005.

.05 *Tracing or Segregating Funds*

A taxpayer is not required to trace or segregate the specific dividend proceeds it receives to demonstrate that it has properly invested the amount of the dividend in the United States pursuant to the domestic reinvestment plan. Moreover, provided a sufficient amount of funds is properly invested in the United States pursuant to the domestic reinvestment plan (and such plan otherwise satisfies the requirements under section 965(b)(4) and this notice), the fact that other non-permitted investments are made during the period covered by such plan generally will not affect the eligibility of the dividend under section 965.

For example, if, pursuant to a domestic reinvestment plan, a taxpayer plans to invest an amount equal to the dividend in infrastructure over a three-year period, the taxpayer is not required to trace or otherwise account for the specific funds that were distributed to the taxpayer and ensure that the same specific funds are invested in the infrastructure over the three-year period. Rather, the taxpayer must demonstrate to the satisfaction of the Commissioner that an amount equal to the dividend is invested in infrastructure pursuant to the domestic reinvestment plan.

In certain cases, however, the fulfillment of a domestic reinvestment plan may be subject to greater scrutiny by the Commissioner because the plan provides that the investment in the United States will only occur over the course of many years, and during such period the taxpayer also is making expenditures that would not be permitted investments. In that case, a segregated account in the amount of the dividend proceeds, with disbursements from the account expended for the permitted investments described in the domestic reinvestment plan, would be a positive factor in establishing that the requirements of section 965(b)(4) are satisfied.

A domestic reinvestment plan may include an investment that, prior to the adoption of the plan, was anticipated to be made by the taxpayer. This is the case even if, prior to the adoption of the domestic reinvestment plan, such investment was budgeted and expected to be made with other funds.

.06 *Expenditures in Taxable Year of Election*

In general, expenditures made during the taxable year for which the taxpayer elects to apply section 965 may be considered to be made pursuant to the domestic reinvestment plan, regardless of when they are made during such year. Thus, for example, expenditures on permitted investments made in the election year but prior to the payment of the cash dividend described in section 965(a) (or prior to the adoption of the domestic reinvestment plan) may qualify as permitted investments made pursuant to the domestic reinvestment plan. Expenditures made during taxable years prior to the taxable year to which the taxpayer elected section 965 to apply, however, will not qualify as permitted investments made pursuant to the domestic reinvestment plan.

.07 *Partially Completed Domestic Reinvestment Plans*

A cash dividend that would otherwise qualify for the DRD under section 965(a) is considered to qualify pursuant to section 965(b)(4) only to the extent the amount of the dividend is expended on permitted investments pursuant to the domestic reinvestment plan. If the domestic reinvestment plan provides for expenditures on permitted investments of the full amount of the dividend, but the U.S. shareholder in fact expends less than the full amount of the dividend on such permitted investments, the dividend satisfies the requirements of section 965(b)(4) only to the extent of the amount so expended. Thus, for example, assume a CFC pays a cash dividend of $100x to its U.S. shareholder pursuant to a domestic reinvestment plan that properly specifies $100x of permitted investments pursuant to section 4 of this notice (and the dividend otherwise qualifies for the DRD under section 965(a)), but the U.S. shareholder in fact only makes $90x of the permitted investments provided for under the plan. In such a case, $10x of the $100x cash dividend does not qualify for the DRD under section 965(a); the remaining $90x qualifies for the DRD under section 965(a).

SECTION 5. EXPENDITURES THAT ARE INVESTMENTS IN THE UNITED STATES PURSUANT TO SECTION 965(b)(4)

.01 *In General*

(a) *Scope*. Except as provided in sections 5.01(b) and (c) of this notice, expenditures described in section 5 of this notice that are made pursuant to a domestic reinvestment plan, as provided under section 965(b)(4) and this notice, are permitted investments. Because this list of permitted investments is not an exclusive list, other investments in the United States made pursuant to a domestic reinvestment plan may also be permitted investments.

(b) *Payments to Unrelated Persons*. Expenditures described in this section 5 are permitted investments only if they are made to a person that is not related to the taxpayer (within the meaning of section 267(b), other than section 267(b)(8) in the case of an expenditure with respect to a qualified plan pursuant to section 5.02 or 5.05(b)).

(c) *Cash Payments*. In general, permitted investments must be made in the form of cash. If a taxpayer issues a note in payment for what would otherwise be a permitted investment, the permitted investment is considered to be made only as the taxpayer satisfies its obligation under the note in cash.

Stock may not be used to make permitted investments. Thus, for example, if a taxpayer issues stock to acquire a target corporation, such acquisition is not a permitted investment (unless, and only to the extent that, cash also is paid for the target company).[5] Similarly, compensation in the form of stock grants or stock options is not a permitted investment.

[5] This is the case even if the acquisition of the target would qualify, in whole or in part, as a permitted investment under section 5.06 of this notice if cash, rather than taxpayer stock, were used to make the acquisition.

.02 *Funding of Worker Hiring, Training, and Other Compensation*

Expenditures incurred in connection with the funding of worker hiring and training (other than as provided in section 6.02 of this notice) are permitted investments. In general, the funding of worker hiring and training includes expenditures incurred in connection with hiring new workers and training both existing and newly-hired workers and expenditures incurred on compensation and benefits (including the funding of a qualified plan within the meaning of section 401(a)) of existing and newly-hired workers.

Expenditures do not qualify, however, to the extent described in section 6.02 of this notice, related to executive compensation. In addition, expenditures qualify only to the extent attributable to services performed by the workers within the United States. If the services are performed partly within and partly without the United States, the amount of permitted investments shall be determined under the principles of §1.861–4(b)(1). Expenditures in this case may be permitted investments even if the workers are not employees of the taxpayer, provided such expenditures are borne by the taxpayer and the activities are performed in the United States.

In the case of funding a qualified plan, a taxpayer may use a reasonable method to apportion the funding between amounts related to executive compensation and non-executive compensation, and between amounts related to services performed within and without the United States. See also section 5.05(b) of this notice (relating to the qualification of satisfaction of an obligation to fund a qualified plan as financial stabilization for the purposes of job retention or creation in the United States).

.03 *Infrastructure and Capital Investments*

Expenditures incurred in connection with the funding of infrastructure and capital investments are permitted investments. Expenditures for infrastructure and capital investments include physical installations and facilities that support the taxpayer's business, and other assets integral to the conduct of a business, provided that the infrastructure and capital investments are located and used in the United States. Such expenditures also include payments for services performed in the United States that are related to, or provided in connection with, otherwise qualified infrastructure or capital investments described in this section.

Infrastructure and capital investments include plant, property and equipment, communications and distribution systems, computer hardware and software, databases, and supporting equipment. Improvements to the items described above also are qualified expenditures.

Expenditures are incurred for infrastructure and capital investments as described above regardless of whether incurred to construct, develop, purchase, rent, or license such items.

If the infrastructure or capital investment is partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment with respect to such item is limited to amounts attributable to assets that are located and used within the United States. Similarly, if services related to, or provided in connection with, qualified infrastructure or capital investments are performed partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment shall be determined under the principles of §1.861–4(b)(1).

.04 *Research and Development*

Expenditures incurred in connection with the funding of research and development are permitted investments. In general, expenditures for research and development are expenditures that are described in §1.174–2, provided that the research and development activities are performed in the United States. In addition, if the research and development is performed partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment shall be determined under the principles of §1.861–4(b)(1).

Expenditures for research and development constitute a permitted investment only to the extent they are borne by the taxpayer. Thus, for example, expenditures incurred on research and development performed by employees of the taxpayer within the United States are not permitted investments to the extent the taxpayer is reimbursed by another party for such activities pursuant to a cost sharing arrangement under §1.482–7.

Expenditures for research and development may be permitted investments even if the research and development is not performed by employees of the taxpayer, provided such expenditures are borne by the taxpayer and the activities are performed in the United States.

.05 *Financial Stabilization of the Corporation for the Purposes of Job Retention or Creation*

(a) *Repayment of debt.* The repayment by the taxpayer of debt, regardless of whether the lender or holder is a U.S. person, is a permitted investment so long as the repayment contributes to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States. The repayment of debt ordinarily will be considered to contribute to the financial stabilization of the taxpayer because it improves the taxpayer's debt-equity ratio and reduces the taxpayer's obligations for debt service. An increase in the taxpayer's credit rating due to the debt repayment is not required. Such an increase, however, would be an indication of a contribution to financial stabilization. The requirement that financial stabilization be for the purposes of job retention or creation in the United States is satisfied if, at the time the domestic reinvestment plan is approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States. In this regard, a plan developed by the taxpayer as part of its strategic planning process that evidences expected use of savings attributable to reduced debt service principally for expenditures incurred in connection with permitted investments is one method of demonstrating a purpose of job retention or creation in the United States because such expenditures likely would have direct or indirect positive effects on employment in the United States.

A repayment of debt is not a permitted investment to the extent, at the time of the repayment, the taxpayer has a plan or intent to incur additional debt on substantially the same terms following the date of the dividend, and the taxpayer in fact incurs such additional debt. In that case, the additional debt, in effect, replaces the repaid debt. Such a temporary or transitory reduction in taxpayer indebtedness is not a permitted investment. The determination of whether the taxpayer had such a plan or intent shall be determined based on all the relevant facts and circumstances, taking into account all relevant provisions and general principles of tax law, including the substance over form doctrine. See, *e.g.*, Rev. Rul. 89–73, 1989–1 C.B. 258.

The taxpayer is not required to demonstrate that there has been a net global reduction in indebtedness of the taxpayer's corporate group in order for the repayment of debt to be a permitted investment. Thus, for example, if a CFC incurs debt (and is treated as the obligor on such debt) to fund a cash dividend it pays to its U.S. shareholder, and the U.S. shareholder uses the dividend proceeds to repay debt owed to an unrelated party, the U.S. shareholder may be able to demonstrate that such repayment is a permitted investment even though the total debt of the taxpayer and its CFCs, taken in the aggregate, is not reduced. If, however, the facts and circumstances are such that, in substance, the taxpayer (rather than the CFC) is the obligor of the debt nominally incurred by the CFC,[6] then the taxpayer simply incurred debt to repay other debt. In such a case, the repayment of the existing debt is transitory and not a permitted investment.

The repayment or acquisition of an intercompany obligation between members of the same consolidated group does not qualify as the repayment of debt for purposes of this section. However, if the consolidated group member receiving funds equal to the repayment or acquisition amount also makes a permitted investment of such amount, such investment may qualify under section 5 of this notice. See section 6.03 of this notice.

(b) *Qualified Plan Funding*. The satisfaction of an obligation to fund a qualified plan (within the meaning of section 401(a)) ordinarily will contribute to the financial stabilization of the taxpayer. The taxpayer is not required to demonstrate the extent to which the plan covers current employees or the extent to which those covered by the plan perform (or performed) services within the United States. The requirement that financial stabilization be for the purposes of job retention or creation in the United States is satisfied if, at the time the domestic reinvestment plan is approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States. See also section 5.02 of this notice (relating to the qualification of expenditures for worker hiring, training and other compensation in the United States as permitted investments).

(c) *Other Expenditures*. Expenditures other than those described in sections 5.05(a) or (b) of this notice also are permitted investments if such expenditures contribute to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States. Whether such an expenditure contributes to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States will be determined based on all the facts and circumstances. Such an expenditure generally will be considered to be a permitted investment if the expenditure reduces financial constraints on the taxpayer's U.S. operations and if, at the time the domestic reinvestment plan is approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that such reduction in financial constraints will be a positive factor in its ability to retain and create jobs in the United States.

.06 *Acquisitions of Interests in Business Entities*

(a) *General Rule*. Except as provided in section 5.06(b) of this notice, the acquisition of an ownership interest in a business entity (such as a corporation or a partnership), regardless of whether such entity is domestic or foreign, is a permitted investment to the extent of the percentage of the total value of the assets owned (directly or indirectly) by the business entity that, if acquired directly, would be permitted investments as described in this notice. The direct or indirect acquisition of an interest in a business entity is a permitted investment only if the taxpayer directly or indirectly owns an interest representing at least 10 percent of the value of such business entity after the acquisition. For purposes of determining whether a taxpayer indirectly owns a 10-percent interest in a business entity, and for purposes of determining whether business entities indirectly own interests in other entities, rules similar to the rules of section 267(c) shall apply.

In general, amounts expended to acquire a direct interest in a business entity shall be allocated between permitted and non-permitted investments on the basis of the relative values of the business entity's assets that, if acquired directly, would be permitted or non-permitted investments. If a business entity owns an interest in another business entity in which the taxpayer indirectly owns a 10-percent interest, the assets taken into account for this purpose are the upper-tier entity's share of the assets held by the lower-tier entity, not the upper-tier entity's interest in the lower-tier entity. In valuing assets for this purpose, the taxpayer must use the same methodology under §1.861–9T(g) (*i.e.*, tax book value, alternative tax book value or fair market value) that the taxpayer uses for purposes of allocating and apportioning interest expense for the taxable year under section 864(e). In applying this section 5.06, however, asset amounts shall be characterized as permitted or non-permitted investments based on whether the assets are located and used within the United States, and not on the basis of the source of the income generated by the assets.

(b) *De Minimis Rule* . If a taxpayer acquires an interest in a business entity as described in section 5.06(a) of this notice, and more than 95 percent of such expenditure would be a permitted investment or a non-permitted investment as determined under section 5.06(a) of this notice, the entire acquisition shall be treated as a permitted investment or a non-permitted investment, respectively.

[6] See, *e.g.*, *Plantation Patterns v. Comm'r*, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).

.07 *Advertising and Marketing Expenditures*

Expenditures incurred on advertising or marketing with respect to trademarks, trade names, brand names, or similar intangible property are permitted investments, provided the advertising or marketing activities are performed in the United States. If the advertising or marketing activities are performed partly within and partly without the United States, the amount that constitutes a permitted investment shall be determined under the principles of §1.861–4(b)(1). As is the case with research and development (discussed in section 5.04 of this notice), the advertising or marketing expenditures must be borne by the taxpayer, but the advertising or marketing activities need not be performed by employees of the taxpayer.

.08 *Intangible Property*

Expenditures to acquire the rights to intangible property, through purchase or license, are permitted investments to the extent the rights to the intangible property are used in the United States.

SECTION 6. EXPENDITURES THAT ARE NOT INVESTMENTS IN THE UNITED STATES PURSUANT TO SECTION 965(b)(4)

.01 *In General*

The expenditures described in this section 6 are not permitted investments by the taxpayer in the United States within the meaning of section 965(b)(4). Section 965(b)(4) explicitly provides that executive compensation is not a permitted investment. The other non-permitted investments listed in this section are not reasonably expected to maintain or add to the value of the taxpayer as a going concern. Because this list of non-permitted investments is not an exclusive list, other expenditures may also be non-permitted investments.

.02 *Executive Compensation*

Executive compensation is not a permitted investment. Executive compensation is defined as compensation paid, directly or indirectly, by or on behalf of, the taxpayer, to any employee or former employee, in exchange for services (past, present, or future) performed for the taxpayer, if: (a) the individual is an employee who is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer; (b) the individual is an employee who would be subject to such requirements if the taxpayer were an issuer of equity securities referred to in such section; or (c) the individual is a former employee who was described in clauses (a) or (b) of this section 6.02 at the time of his or her severance from employment. A taxpayer may treat the ten employees who received the highest wages in the most recently ended calendar year as being the individuals described in clause (b) of this section 6.02.

.03 *Intercompany Distributions, Obligations, and Transactions*

For purposes of section 965, all U.S. shareholders that are members of an affiliated group filing a consolidated return under section 1501 are treated as one U.S. shareholder. Section 965(c)(5). Therefore, intercompany distributions, intercompany obligations, and intercompany transactions (all as defined in §1.1502–13) between corporations that are members of the same consolidated group are disregarded for purposes of section 965 and cannot be permitted investments under section 5 of this notice. However, if a consolidated group member initially receives a cash dividend from its CFC, an investment of an amount equal to such dividend amount made by another consolidated group member may be a permitted investment under section 5 of this notice.

.04 *Dividends and Other Distributions With Respect to Stock*

Dividends and other distributions made by the taxpayer to its shareholders with respect to its stock, without regard to how such distributions are treated under section 301, are not permitted investments because they do not constitute investments by the taxpayer for purposes of section 965.

Moreover, although intercompany distributions between members of a consolidated group are disregarded for purposes of section 965, a distribution with respect to the stock of a consolidated group member that is held by a person that is not a member of the same consolidated group is not a permitted investment.

.05 *Stock Redemptions*

The redemption of outstanding stock of a taxpayer or, through one or more steps as part of a plan, of a corporation related to the taxpayer (within the meaning of section 267(b)) without regard to whether such redemption is treated as an exchange in part or full payment for the stock under section 302(b), is not a permitted investment. As is the case with dividends, such expenditures do not constitute investments by the taxpayer for purposes of section 965.

Moreover, although an intercompany transaction in which a consolidated group member acquires its own stock from another consolidated group member is disregarded for purposes of section 965, a redemption of shares of stock of a consolidated group member that are held by a person that is not a member of the same consolidated group is not a permitted investment.

.06 *Portfolio Investments in Business Entities*

Except as provided in section 5.06 of this notice, the acquisition of an interest in a business entity is not a permitted investment.

.07 *Debt Instruments or other Evidences of Indebtedness*

The acquisition of a debt instrument or other evidence of indebtedness, including an acquisition of such instrument or indebtedness from the debtor, is not a permitted investment.

.08 *Tax Payments*

Payments of federal, state, local or foreign taxes, and associated interest and penalties, including foreign withholding tax and U.S. federal, state or local income tax imposed on distributions that qualify as cash dividends under section 965(a), are not permitted investments.

SECTION 7. ELECTION TO APPLY SECTION 965 TO A TAXABLE YEAR

In general, a taxpayer elects to apply section 965 to a taxable year by filing Form 8895 with its timely-filed tax return (including extensions) for such taxable year. If, however, a taxpayer files its tax return for the taxable year to which the taxpayer intends to elect section 965 to apply prior to the issuance of Form 8895, the election must be made on a statement that is attached to its timely-filed tax return (including extensions) for such taxable year. See section 9.03 for a special transition rule for certain tax returns filed prior to January 13, 2005.

SECTION 8. REPORTING AND OTHER ADMINISTRATIVE REQUIREMENTS

.01 *In General*

The determination of whether the dividend has been invested in the United States pursuant to the domestic reinvestment plan as provided under section 965(b)(4) is generally made under the facts and circumstances of the particular taxpayer, as described in section 8.04 of this notice. However, section 8.03 of this notice provides a safe harbor method under which the taxpayer will be considered to have established to the satisfaction of the Commissioner that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan.

Section 8.02 of this notice sets forth reporting and documentation requirements with respect to section 965.

.02 *Reporting and Documentation Requirements*

(a) *Annual Reporting*. The taxpayer shall attach a statement which includes the items described below to its timely-filed tax return (including extensions) for the taxable year to which the taxpayer's election under section 965 applies and for each subsequent taxable year at the beginning of which the taxpayer has not made all investments required to be made under one or more of its domestic reinvestment plans (unless the annual reporting requirement is terminated earlier pursuant to sections 8.03(c)(i) or 8.04(c)(ii) of this notice):

(i) A statement that the document is submitted pursuant to section 965(b)(4) and this notice.

(ii) A general description of any permitted investment made during the taxable year pursuant to the domestic reinvestment plan and a reconciliation over the entire term of such plan through the last day of the taxable year for which the statement is filed of the specific expenditures made with respect to each such investment. The description must include a calculation of the percentage of completion of the domestic reinvestment plan. The percentage of completion of the plan is calculated as the sum of the expenditures made and amounts subject to a binding contract or commitment (as described in section 8.03(b)(i) of this notice) through such last day, divided by the total amount to be invested pursuant to the plan.

(iii) A statement indicating whether any of the permitted investments that have been made pursuant to the domestic reinvestment plan are alternative investments.

(iv) Such additional items, as applicable, pursuant to sections 8.03 and 8.04 of this notice.

(b) *Documentation and Production*. The taxpayer shall, with respect to each of its domestic reinvestment plans, prepare, maintain, and, upon a request by the Commissioner, make available within 30 days of such request, the following:

(i) Records that display in reasonable detail the amount invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4)(B). The documentation must also include an allocation between permitted investments and non-permitted investments and, as relevant, a demonstration that the methodology used is consistent with the principles prescribed in this notice. For example, if the taxpayer acquires a 10-percent interest in a business entity that directly or indirectly owns assets that, if acquired directly, would consist of both permitted and non-permitted investments, an analysis of the allocation of the expenditure between permitted and non-permitted assets under the principles described in section 5.06 of this notice is required.

(ii) A copy of the domestic reinvestment plan and any supporting documents.

(iii) In the case of a cash dividend that is effectuated through an intermediary partnership (as described in section 3.02 of this notice) that is foreign and is not required under section 6031 to file an information return, substantiation that the applicable requirements set forth in section 3.02 of this notice (regarding allocations under sections 702 and 704, and the separate statement of items pursuant to §1.702–1(a)(8)(ii)) were met.

.03 *Safe Harbor*

(a) *In General*. If a taxpayer meets the requirements under sections 8.03(b), 8.03(c), and 8.03(d) of this notice, then the taxpayer will have established to the satisfaction of the Commissioner that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). This safe harbor is not the exclusive method of satisfying the Commissioner. If the safe harbor is not met, the determination will be made under a facts and circumstances analysis described in section 8.04 of this notice.

(b) *Substantive Requirements*. Expenditures comprising at least 60 percent of the amount of total funds with respect to permitted investments to be made pursuant to the domestic reinvestment plan meet both of the following requirements:

(i) Such expenditures have been made, or are the subject of a binding contract or commitment entered into with persons unrelated to the taxpayer (within the meaning of section 267(b), other than section 267(b)(8)), by the end of the second taxable year following the taxable year for which the taxpayer elected to apply section 965; and —

(ii) Such expenditures constitute permitted investments listed in section 5 of this notice (other than investments described in section 5.05(c) of this notice).

(c) *Annual Reporting*. The taxpayer satisfies the reporting requirements of section 8.02(a) of this notice for the taxable year for which the taxpayer elected section 965 to apply and each of the two subsequent taxable years (unless all investments have been made pursuant to the domestic reinvestment plan prior to the beginning of either such taxable year) and includes in such reporting the representations set forth below, as applicable:

(i) In an annual report filed for a taxable year no later than the second taxable year following the taxable year to which the taxpayer elected to apply section 965, representations —

(A) that the requirements of section 8.03(b) of this notice have been met; and

(B) that the taxpayer intends to make the remaining amount of investments, if any, pursuant to the domestic reinvestment plan no later than the end of the fourth taxable year following the taxable year to which the taxpayer elected to apply section 965.

A taxpayer may cease annual reporting pursuant to section 8.02(a) and this section 8.03(c) after such statement including such representations is filed.

(ii) If the repayment of debt during the taxable year is intended to qualify as a permitted investment pursuant to section 5.05(a) of this notice, representations —

(A) That such repayment of debt contributes to the financial stabilization of the taxpayer in the United States in accordance with section 5.05(a) of this notice;

(B) That at the time the domestic reinvestment plan was approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment was that the financial stabilization resulting from such repayment of debt will be a positive factor in its ability to retain and create jobs in the United States in accordance with section 5.05(a) of this notice; and

(C) That, at the time of the repayment, the corporation had no plan or intent to incur additional debt under substantially the same terms in accordance with section 5.05(a) of this notice.

(iii) If the satisfaction of an obligation to fund a qualified plan (within the meaning of section 401(a)) is intended to qualify as a permitted investment pursuant to section 5.05(b) of this notice, representations —

(A) That such satisfaction of a qualified plan funding obligation contributes to the financial stabilization of the taxpayer in accordance with section 5.05(b) of this notice; and

(B) That at the time the domestic reinvestment plan was approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment was that the financial stabilization resulting from such satisfaction of a qualified plan funding obligation will be a positive factor in its ability to retain and create jobs in the United States in accordance with section 5.05(b) of this notice.

(d) *Documentation and Production*. The taxpayer satisfies the documentation and production requirements of section 8.02(b) of this notice.

.04 *Facts and Circumstances*

(a) *In General*. If a taxpayer does not satisfy the safe harbor described in section 8.03 of this notice, the taxpayer must establish to the satisfaction of the Commissioner that, taking into account the facts and circumstances, the amount of the dividend has been, or will be, invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). The fact that the safe harbor has not been satisfied, however, is not relevant in determining whether the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). Among the facts and circumstances that may be relevant in establishing to the satisfaction of the Commissioner that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4) are those in sections 8.04(b), 8.04(c), and 8.04(d) of this notice.

(b) *Relevant Facts and Circumstances*. Relevant facts and circumstances for purposes of this section 8.04 include:

(i) The time period prescribed in the domestic reinvestment plan, taking into account the nature of the investments to be made in the United States and other facts and circumstances, during which the taxpayer anticipates completing all investments to be made pursuant to the domestic reinvestment plan. See section 4.03 of this notice.

(ii) The degree of specificity used in the domestic reinvestment plan describing anticipated permitted investments. See section 4.03 of this notice.

(iii) The extent to which the taxpayer has completed the investment of the dividend in the United States as required under section 965(b)(4), taking into account the nature of the investments to be made in the United States and other facts and circumstances.

(c) *Annual Reporting*. Relevant facts and circumstances also include the extent to which the taxpayer has complied with the reporting requirements described in section 8.02(a) of this notice, and whether the taxpayer includes in an annual report filed for the taxable year no later than the second taxable year following the taxable year to which the taxpayer elected to apply section 965 the following representations:

(i) that the taxpayer will agree, upon a request by the Commissioner, to enter into an agreement to extend the statute of limitations on assessment and collection with respect to the DRD claimed under section 965(a) for the taxable year to which the taxpayer elected to apply section 965; and

(ii) that the taxpayer will agree, upon a request by the Commissioner, to enter into a multi-year agreement with respect to the taxpayer's completion of the domestic reinvestment plan.

An agreement entered into with the Commissioner may determine the extent of any continuing reporting and documentation requirements pursuant to this section 8.04(c) and section 8.04(d) of this notice.

(d) *Documentation and Production*. Relevant facts and circumstances also include the extent to which the taxpayer satisfies the documentation and production requirements of section 8.02(b) of this notice.

SECTION 9. TRANSITION RULES

.01 *In General*.

All domestic reinvestment plans are subject to the guidance provided in this notice. Thus, for example, expenditures described in Section 6 of this notice are non-permitted investments, even if such expenditures were made prior to the issuance of this notice.

.02 *Dividends Paid Prior to January 13, 2005*.

If a domestic reinvestment plan approved prior to January 13, 2005 is not in conformity with the guidance provided in this notice, the taxpayer may modify such plan to comply with the guidance herein not later than March 14, 2005, even if the dividend (or dividends) to which the plan relates has already been paid. Any domestic reinvestment plan that is so modified must be subsequently approved by the taxpayer's president, chief executive officer, or comparable official, and by the taxpayer's board of directors, management committee, executive committee, or similar body.

.03 *Tax Returns Filed Prior to January 13, 2005.*

A taxpayer that has filed its tax return for the taxable year for which it elects section 965 to apply prior to January 13, 2005, may satisfy the reporting requirements of sections 8.02(a), 8.03(c) or 8.04(c) of this notice on an amended tax return that is filed by the due date (including extensions) of the tax return for such taxable year.

SECTION 10. EFFECTIVE DATE

This notice is effective for the taxable year for which taxpayers have elected section 965 to apply, and subsequent taxable years as relevant.

SECTION 11. PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1926.

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.

The collections of information are in sections 7, 8, and 9 of this notice. This information is required to provide the IRS sufficient information to determine whether a taxpayer has properly elected to apply section 965 to a taxable year, to determine whether a dividend has been invested in the United States pursuant to a domestic reinvestment plan under section 965(b)(4), and to determine whether a taxpayer has properly applied certain transition rules. The collections of information are required to obtain the benefit of section 965 for a taxable year. The likely respondents are business corporations.

Estimated total annual reporting and/or recordkeeping burden: 3,750,000 hours.

Estimated average annual burden hours per respondent: 150 hours.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: on occasion and annually.

The collections of information contained in this notice have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be received by February 14, 2005. Comments are specifically requested concerning:

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

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

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

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

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

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

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.

SECTION 12. DRAFTING INFORMATION

The principal author of this notice is Jeffrey L. Vinnik of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice, contact Mr. Vinnik at (202) 622–3840 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Flat Rate Supplemental Wage Withholding

REG–152945–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations amending the regulations that provide for the flat rate of withholding applicable to calculating the amount of income tax withholding on supplemental wages. The proposed amendment to the regulations reflects changes in the law made by the Revenue Reconciliation Act of 1993, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Jobs Creation Act of 2004. Under the American Jobs Creation Act of 2004, the optional flat rate for withholding on supplemental wages will generally remain at 25 percent for payments made after December 31, 2004, but may change if income tax rates change. However, the 2004 Act also provides that, after 2004, if an employee receives supplemental wages in excess of one million dollars from an employer in a calendar year, the excess of the supplemental wages over one million dollars is subject to mandatory income tax withholding at the highest income tax rate. The highest income tax rate is currently 35 percent. In determining whether an employer has reached the one million dollar threshold for an employee, supplemental wage payments from all businesses under common control and from agents will be taken into account.

DATES: Written or electronic comments and requests for a public hearing must be received by April 11, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–152945–04), 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–152945–04), 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–152945–04).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, A. G. Kelley, (202) 622–6040; concerning submission of comments, Treena Garrett, (202) 622–3401 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The Employment Tax Regulations distinguish between regular wages paid for a payroll period and supplemental wages for purposes of income tax withholding. Although the regulations do not give a comprehensive definition of the term "supplemental wages," the regulations provide that supplemental wages include "…bonuses, commissions, and overtime pay, paid for the same or a different period, or without regard to a particular period." Regulations and revenue rulings have provided other examples. See §31.3401(a)–1(b)(8)(i)(*b*)(*2*) of the regulations (sick pay paid by an agent of the employer); §31.3401(a)–4(c) of the regulations (wages paid under reimbursement and other expense allowance arrangements); Rev. Rul. 67–257, 1967–2 C.B. 359 (income recognized on exercise of nonqualified stock option); Rev. Rul. 67–131, 1967–1 C.B. 291 (lump sum payment of accumulated annual leave); and Rev. Rul. 66–294, 1966–2 C.B. 459 (lump sum vacation payment, overtime pay, lump sum retroactive pay, sick pay paid separately from regular pay).

Section 31.3402(g)–1 of the regulations provides the current rules for withholding income tax from a payment of supplemental wages. Two procedures have been generally available to the employer with respect to such supplemental wage payments. Under the first procedure (the aggregate procedure), employers calculate the amount of withholding due by aggregating the amount of supplemental wages with the regular wages paid for the current payroll period or for the most recent payroll period this year, and treating the aggregate as if it were a single wage payment for the regular payroll period.

The second procedure for withholding on supplemental wages (the flat rate procedure) allows employers to disregard the amount of regular wages paid to an employee as well as the allowances claimed by an employee on Form W–4, "*Employee's Withholding Allowance Certificate*", and use a flat percentage rate specified in the regulations in calculating the amount of withholding. This second procedure of withholding on supplemental wages is generally available only if (1) the employer has withheld income tax from regular wages paid the employee, and (2) the supplemental wages are either (a) not paid concurrently with regular wages or (b) separately stated on the payroll records of the employer. See Rev. Rul. 82–200, 1982–2 C.B. 239. Under the current regulations, if the supplemental wage payment satisfies the conditions necessary for use of the flat rate, the decision whether to use the flat rate rather than the aggregate procedure is discretionary with the employer. Section 31.3402(g)–1(a)(2), last modified in 1966, states that, for wages paid after April 30, 1966, the flat percentage rate on supplemental wages is 20 percent. Later statutory changes have changed the applicable rate and the regulation is being amended to reflect those changes.

Section 13273 of Public Law 103–66 (the Revenue Reconciliation Act of 1993; 107 Stat. 542) provides that the rate under section 31.3402(g)–1 "shall not be less than 28 percent." This change was effective for payments made after December 31, 1993. The Conference Report in connection with this change states that the provision "increases the applicable withholding rate on supplemental wage payments to 28 percent." H.R. Rep. No. 103–111, 103d Cong., 1st Sess. 701 (1993).

Section 101(c)(11) of Public Law 107–16 (the Economic Growth and Tax Relief Reconciliation Act of 2001; 115 Stat. 44) amended section 13273 of the

Revenue Reconciliation Act of 1993 by striking "28 percent" and inserting "the third lowest rate of tax applicable under section 1(c) of the Internal Revenue Code of 1986." Section 101(d)(2) of Public Law 107–16 provides that the change made by section 101(c)(11) shall apply to "amounts paid after the 60th day after the date of enactment of this Act." Public Law 107–16 was enacted into law on June 7, 2001. The third lowest rate of tax applicable under section 1(c) for purposes of section 13273 of the Revenue Reconciliation Act of 1993 was 27.5 percent. Consequently, the withholding rate for supplemental wages paid after August 6, 2001, and on or before December 31, 2001, was 27.5 percent. For 2002 the third lowest rate of tax applicable under section 1(c) was 27 percent. As a result of the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108–27) on May 28, 2003, the third lowest rate of tax applicable under section 1(c) of the Internal Revenue Code (Code) for 2003 and 2004 is 25 percent.

Section 904(a) of Public Law 108–357, 118 Stat. 1418 (the American Jobs Creation Act of 2004) provides that, generally, for payments after December 31, 2004, the flat rate for withholding on supplemental wage rate "shall not be less than 28 percent (or the corresponding rate in effect under section 1(i)(2) of the Internal Revenue Code of 1986 for taxable years beginning in the calendar year in which the payment is made)." For 2005, the corresponding rate in effect under section 1(i)(2) is 25 percent.

Section 904(b) of the American Jobs Creation Act of 2004 also established a mandatory flat rate of withholding on supplemental wages to the extent that the employee's total supplemental wages paid by the employer exceed one million dollars during the calendar year. Section 904(b) provides that "[n]otwithstanding subsection (a), if the supplemental wage payment, when added to all such payments previously made by the employer to the employee during the calendar year, exceeds $1,000,000, the rate used with respect to such excess shall be equal to the maximum rate of tax in effect under section 1 of such Code for such taxable years beginning in such calendar year." The maximum rate of tax in effect under section 1 of the Code is currently 35 percent. Section 904(b)(2) also provides that all persons treated as a single employer under subsection (a) or (b) of section 52 of the Code shall be treated as a single employer for purposes of this provision. This new mandatory withholding on supplemental wages in excess of one million dollars is effective with respect to payments made after December 31, 2004.

This provision is described in the Conference Report as follows: "Under the Senate amendment, once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (35 percent for 2004 and 2005), regardless of any other withholding rules and regardless of the employee's Form W–4." H.R. Rep. No. 108–475 at 785–6 (2004).

This provision for withholding on supplemental wages in excess of one million dollars was originally included as part of S. 2424, 108th Cong., 2d Sess. (2004). The legislative history in connection with S. 2424 provided as follows with respect to the reasons for change: "The Committee believes that because most employees who receive annual supplemental wage payments in excess of $1 million will ultimately be taxed at the highest rate, it is appropriate to raise the withholding rate on such payments so that withholding more closely approximates the ultimate tax liability with respect to these payments." S. Rep. No. 108–266 at 105 (2004).

In a conforming amendment, the 2004 Act repealed section 13273 of the Revenue Reconciliation Act of 1993.

Explanation of Provisions

The proposed regulations change the optional flat rate of withholding on supplemental wages to provide that the 20 percent rate applies only to supplemental wages paid prior to January 1, 1994. The rate of 28 percent applies to supplemental wages paid after December 31, 1993, and on or before August 6, 2001. The Revenue Reconciliation Act of 1993, as amended by the Economic Growth and Tax Relief Reconciliation Act of 2003, provides that the supplemental withholding rate shall not be less than the third lowest rate of tax applicable under section 1(c) for wages paid after August 6, 2001, and before January 1, 2005. Consistent with this amendment, the regulations provide that the rate of 27.5 percent applies to supplemental wages paid after August 6, 2001, and on or before December 31, 2001, the rate of 27 percent applies to wages paid after December 31, 2001, and on or before May 27, 2003, and the rate of 25 percent applies to wages paid after May 27, 2003, and on or before, December 31, 2004. Although the Jobs and Growth Tax Relief Reconciliation Act of 2003 provided that the third lowest rate of tax under section 1(c) after December 31, 2002, would be 25 percent, this provision was not enacted into law until May 28, 2003. Thus, at the time of payments of supplemental wages made after December 31, 2002, and prior to May 28, 2003, the third lowest rate of tax under section 1(c) was 27 percent. This provision is consistent with the general principle that the employment taxation of wage payments is determined based on the rates in effect at the date the wages are paid. *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001).

To track the statutory language of the American Jobs Creation Act of 2004, the regulation provides that, for wages paid after December 31, 2004, the flat rate for supplemental wages is generally 28 percent (or the corresponding rate in effect under section 1(i)(2) … for taxable years beginning in the calendar year in which the payment is made). Under current law, the corresponding rate in effect under section 1(i)(2) for taxable years beginning in 2005 is 25 percent. Thus, for 2005, the optional flat rate for supplemental wages under $1 million in a given taxable year is 25 percent. The optional flat rate will remain at 25 percent until income tax rates change.[1] However, as described below, a higher mandatory rate applies for withholding on supplemental wages in excess of one million dollars.

The regulation provides that if a supplemental wage payment, together with all other supplemental wage payments paid

[1] Under current law, section 1(i)(2) will not be applicable to taxable years beginning after December 31, 2010, pursuant to the sunset provisions contained in section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107–16; 115 Stat. 150). See also section 107 of Public Law 108–27 (117 Stat. 755). Absent legislative action, the optional flat rate will change to 28 percent in 2011.

by an employer to an employee during the calendar year, exceeds one million dollars, the withholding rate on the supplemental wages in excess of one million dollars shall be equal to the maximum rate of tax in effect under section 1 for taxable years beginning in such calendar year. Under current law, the maximum rate of tax in effect for taxable years beginning in 2005 is 35 percent. Thus, in 2005, the mandatory flat rate for supplemental wages in excess of $1 million in a given taxable year is 35 percent. The mandatory rate will remain at 35 percent until income tax rates change.[2]

These proposed regulations also clarify which wages are classified as supplemental wages. Under the proposed regulations, supplemental wages include any payment of wages by an employer that is not regular wages. Regular wages are defined as amounts paid by an employer for a payroll period either at a regular hourly rate or in a predetermined fixed amount. Wages that vary from payroll period to payroll period based on factors other than the amount of time worked, such as commissions, tips, and bonuses, are supplemental wages if they are paid in addition to regular wages. See Rev. Rul. 82–46, 1982–1 C.B. 158. However, if an employee receives only one type of compensation from an employer, that type of compensation will be regular wages even if the type of compensation is something that would normally be classified as supplemental wages. For example, if an employee receives only stock options as compensation from the employer and receives no other wages (including no includible fringe benefits that are wages), then the income on the exercise of the options would generally be regular wages, rather than supplemental wages.

The definitions of supplemental wages and regular wages were developed based on the historical usage of the term in regulations and revenue rulings. Examples are included in the regulations to illustrate the application of the definitions to specific scenarios. The IRS welcomes comments on whether this definition of supplemental wages is appropriate.

When determining whether payments are regular wages or supplemental wages, and furthermore, whether the supplemental wages paid by an employer to an employee in a given taxable year exceed $1 million, an employer (the first employer) must consider wage payments made to the employee by any other person treated as a single employer with the first employer under section 52(a) or 52(b). Furthermore, if an employer enlists a third party to make a payment to an employee on the employer's behalf, the payment will be considered as made by the employer even though it may have been delivered to the employee by the third party.

The new mandatory withholding rate on supplemental wages can apply to a full payment or only a portion of a payment. The maximum rate withholding applies only to the excess of supplemental wages over one million dollars received by an employee from an employer, taking into consideration all payments of supplemental wages made by an employer to an employee. All payments of supplemental wages are considered in determining this threshold regardless of whether the payments were subjected to flat rate withholding. The amount of regular wages paid to the employee has no relevance in determining whether the new mandatory withholding rate applies. Also, if a payment to an employee from an employer is not "wages" as defined under section 3401(a), such payment has no effect on whether the million dollar threshold for mandatory flat rate withholding has been reached.

If a particular supplemental wage payment results in an employee exceeding the million dollar supplemental wage threshold, mandatory flat rate withholding will apply to the extent that the payment together with other supplemental wage payments made to the employee previously during the year is in excess of one million dollars. However, to the extent that such a supplemental wage payment does not exceed one million dollars when combined with the other previous supplemental wage payments, the mandatory flat rate does not apply, and withholding may be calculated on that portion of the payment under the rules generally applicable to other supplemental wage payments.

Withholding on regular wages of the employee will continue to be calculated under the method used by the employer with respect to regular wages after the employee has reached the million dollar supplemental wage threshold.

The regulations also clarify that the mandatory flat rate applies regardless of the withholding method used by the employer with respect to regular wages. The regulations also clarify that mandatory flat rate withholding applies even if the employee receiving the supplemental wages in excess of $1 million has a Form W–4 asserting exempt status pursuant to section 3402(n). Moreover, the regulations also clarify that mandatory flat rate withholding applies to noncash remuneration paid to a retail commission salesperson (section 3402(j)) to the extent that such remuneration constitutes supplemental wages and exceeds $1 million in a given taxable year.

Examples of how the withholding would be calculated under the mandatory flat rate are included in the regulation. Among other things, the examples illustrate that because the higher rate is mandatory, where an employer provides net bonuses (*i.e.*, after withholding) at a specified level, the total of the amount of such net bonuses and the gross up for withholding that are in excess of $1 million of supplemental wages will be subject to the higher rate.

The proposed regulations also clarify that, generally, where an employer has paid an employee supplemental wages that are cumulatively one million dollars or less for a given taxable year, the flat rate of withholding on supplemental wages can be used only if (1) income tax has been withheld from the employee's regular wages and (2) the supplemental wages are either not paid concurrently with regular wages of the employee or if paid concurrently with regular wages, are separately stated on the payroll records of the employer.

The proposed regulations do not change the Federal Insurance Contributions Act (FICA) taxation of wages.

Proposed Effective Date

This regulation will be effective on the date published as a final regulation in the **Federal Register**.

[2] Under the sunset provision in section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001, the mandatory flat rate will change to 39.6 percent for taxable years beginning after December 31, 2010.

Special Analyses

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

Comments and Requests for Public Hearing

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

Drafting Information

The principal author of these regulations is A. G. Kelley, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

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

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

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

Section 31.3402(n)–1 also issued under 26 U.S.C. 6001, 6011 and 6364. * * *

Par. 2. Section 31.3401(a)–1 is amended by revising paragraph (b)(8)(i)(*b*)(*2*) as follows:

§31.3401(a)–1 Wages

* * * * *

(b) * * *

(8) * * *

(i) * * *

(*b*) * * *

(*2*) Payments made by agents subject to this paragraph are supplemental wages as defined in §31.3402(g)–1, and are therefore subject to the rules regarding withholding tax on supplemental wages provided in §31.3402(g)–1. For purposes of those rules, unless the agent is also an agent for purposes of withholding tax from the employees' regular wages, the agent may deem tax to have been withheld from regular wages paid to the employee during the calendar year.

* * * * *

Par. 3. Section 31.3401(a)–4 is amended by revising paragraph (c) to read as follows:

§31.3401(a)–4 Reimbursements and other expense allowance amounts.

* * * * *

(c) *Withholding rate*. Payments made under reimbursement or other expense allowance arrangements that are subject to income tax withholding are supplemental wages under §31.3402(g)–1 if paid in addition to regular wages. Accordingly, withholding on such supplemental wages is calculated under the rules provided with respect to supplemental wages in §31.3402(g)–1.

* * * * *

Par. 4. Section 31.3402(g)–1 is amended by:

(1) Revising paragraph (a).

(2) Adding a sentence at the beginning of paragraph (b)(1).

(3) Revising paragraph (b)(2).

The revisions and addition read as follows:

§31.3402(g)–1 Supplemental wage payments.

(a) *In general and withholding applicable with respect to supplemental wages in excess of $1,000,000.* (1)(i) An employee's remuneration may consist of regular wages and supplemental wages. Supplemental wages are all wages paid by an employer that are not regular wages. Supplemental wages include wage payments made without regard to an employee's payroll period, but also may include payments made for a payroll period. Examples of wage payments that are included in supplemental wages, if paid in addition to regular wages, include bonuses, overtime pay, back pay, reported tips, commissions, wages paid under reimbursement or other expense allowances, wages paid as noncash fringe benefits, sick pay paid by a third party as an agent of the employer, amounts that are includible in gross income under section 409A, and income recognized on the exercise of a nonqualified stock option.

(ii) As distinguished from supplemental wages, regular wages are amounts that are paid at a regular hourly, daily, or similar periodic rate (and not an overtime rate) for the current payroll period or at a predetermined fixed determinable amount for the current payroll period. Thus, among other things, wages that vary from payroll period to payroll period (such as commissions, tips, or bonuses) are not regular wages if paid in addition to regular wages. Any overtime pay paid in addition to regular wages would not be included in regular wages. However, if the only wages that an employee receives during a calendar year are bonuses, commissions, tips, or another type of payments that would normally be classified as supplemental wages if paid in addition to regular wages, then such wages are treated as regular wages. For example, if the only wages an employee receives are commissions paid on a monthly basis, then the payment of the commissions by the employer would be regular wages paid for a monthly payroll period.

(iii) The calculation of the amount of the income tax withholding with respect to supplemental wage payments is provided for under paragraph (a)(2) through (a)(7) of this section.

(2) If a supplemental wage payment, when added to all supplemental wage pay-

ments previously made by one employer (as defined in paragraph (a)(3) of this section) to an employee during the calendar year, exceeds $1,000,000, the rate used in determining the amount of withholding on the excess (including any excess which is a portion of a supplemental wage payment) shall be equal to the highest rate of tax applicable under section 1 for such taxable years beginning in such calendar year. This flat rate shall be applied without regard to whether income tax has been withheld from the employee's regular wages, without allowance for the number of withholding allowances claimed by the employee on Form W–4, "*Employee's Withholding Allowance Certificate*", without regard to whether the employee has claimed exempt status on Form W–4, and without regard to the withholding method used by the employer.

(3) For purposes of paragraph (a)(2) of this section, including for purposes of determining whether any given payment is a payment of supplemental wages subject to paragraph (a)(2) of this section —

(i) All persons treated as a single employer under subsection (a) or (b) of section 52 shall be treated as one employer; and

(ii) Any payment made to an employee by a third party acting as an agent for the employer (regardless of whether such person shall have been designated as an agent pursuant to section 3504) shall be considered as made by the employer.

(4) To the extent that paragraph (a)(2) of this section does not apply to a supplemental wage payment (or a portion of a payment), the amount of the tax required to be withheld on the supplemental wages when they are paid shall be determined under the rules provided in paragraphs (a)(5) and (6) of this section.

(5)(i) The employer is required to determine withholding upon supplemental wages under this paragraph (a)(5) if paragraph (a)(2) of this section does not apply to the payment or portion of the payment and if paragraph (a)(6) of this section may not be used with respect to the payment. In addition, employers have the option of using this paragraph (a)(5) to calculate withholding with respect to a supplemental wage payment, if paragraph (a)(2) of this section does not apply to the payment, but if paragraph (a)(6) of this section could be used with respect to the payment.

(ii) Provided this procedure applies under paragraph (a)(5)(i) of this section, the supplemental wages, if paid concurrently with wages for a payroll period, are aggregated with the wages paid for such payroll period. If not paid concurrently, the supplemental wages are aggregated with the wages paid or to be paid within the same calendar year for the last preceding payroll period or for the current payroll period. The amount of tax to be withheld is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period.

(6)(i) The employer may determine withholding upon supplemental wages under this paragraph (a)(6) if three conditions are met —

(A) Paragraph (a)(2) of this section does not apply to the payment or the portion of the payment;

(B) The supplemental wages are either not paid concurrently with regular wages or are separately stated on the payroll records of the employer; and

(C) Income tax has been withheld from the employee's regular wages.

(ii) The determination of the tax to be withheld under paragraph (a)(6)(iii) of this section is made without allowance for exemption and without reference to any payment of regular wages.

(iii) Provided the conditions of paragraph (a)(6)(i) of this section have been met, the employer may determine the tax to be withheld —

(A) From supplemental wages paid after April 30, 1966, and prior to January 1, 1994, by using a flat percentage rate of 20 percent;

(B) From supplemental wages paid after December 31, 1993, and on or before August 6, 2001, by using a flat percentage rate of 28 percent;

(C) From supplemental wages paid after August 6, 2001, and on or before December 31, 2001, by using a flat percentage rate of 27.5 percent;

(D) From supplemental wages paid after December 31, 2001, and on or before May 27, 2003, by using a flat percentage rate of 27 percent;

(E) From supplemental wages paid after May 27, 2003, and on or before December 31, 2004, by using a flat percentage rate of 25 percent; and

(F) From supplemental wages paid after December 31, 2004, by using a flat percentage rate of 28 percent (or the corresponding rate in effect under section 1(i)(2) for taxable years beginning in the calendar year in which the payment is made).

(7) The following examples illustrate this paragraph (a):

Example 1. (i) A is an employee of three entities (X, Y, and Z) that are treated as a single employer under section 52(a) or (b). In year 20XX, A receives regular wages on a monthly payroll periods paid by X for services performed for X, Y, and Z on the third business day of each month. The maximum rate of income tax under section 1 in effect for year 20XX is 35 percent, and the corresponding rate to 28 percent in effect under section 1(i)(2) for taxable years beginning in 20XX is 25 percent. Income tax is withheld from the regular wages of A during the year. A receives only the following supplemental wage payments during 20XX in addition to the regular wages paid by X —

(a) a bonus of $600,000 from X on March 15, 20XX;

(b) a bonus of $2,300,000 from Y on November 15, 20XX; and

(c) a bonus of $10,000 from Z on December 31, 20XX.

(ii) In this *Example 1*, the withholding on the $600,000 payment from X could be determined under either paragraph (a)(5) or (6) of this section because income tax has been withheld from the regular wages of A. If X elects to use the aggregate procedure under paragraph (a)(5) of this section, the amount of withholding on the supplemental wages would be based on aggregating the supplemental wages and the regular wages paid by X either for the current or last payroll period and treating the total of the regular wages paid by X and the $600,000 supplemental wages as a single wage payment for a regular payroll period. The withholding method used by the employer with respect to regular wages would then be used to calculate the withholding on this single wage payment, and the employer would take into consideration the Form W–4 filed by the employee.

(iii) In this *Example 1*, because the $2,300,000 bonus from Y, together with the regular wages paid by X, is treated as made from one employer, the payment is a supplemental wage payment. To calculate the withholding on the $2,300,000 supplemental wage payment from Y, it would be necessary to take into account that A has already received $600,000 of supplemental wages from X, which is treated as the same employer as Y under section 52(a) or (b). Thus, the withholding on the amount of the payment not in excess of $1,000,000 cumulative supplemental wages would need to be computed separately from the amount of the payment above $1,000,000. With respect to the first component of this supplemental wage payment, equal to $400,000, the withholding could be computed under either paragraph (a)(5) or (a)(6) of this section, because income tax has been withheld from the regular wages of the employee. If Y elected to withhold income tax using paragraph (a)(6) of this section, Y would withhold on the $400,000 component at 25 percent (pursuant to paragraph (a)(6)(ii)(F) of this section), which would result in $100,000 tax withheld. The second component of $1,900,000 would be subject to mandatory income tax withholding at the maximum rate of tax in effect under section 1 for 20XX. The income tax required to be withheld on the second component of this supplemental wage payment would be calculated without regard to the Form W–4 filed by A and would be 35 percent of $1,900,000 or $665,000. The withholding on the first component and the withholding on the second component then would be added together to determine the total income tax withholding on the supplemental wage payment from Y, or $100,000 plus $665,000 ($765,000).

(iv) The bonus paid from Z is also a supplemental wage payment, because Z, together with X, is treated as a single employer. The calculation of the withholding on the supplemental wage payment from Z to A of $10,000 would also be required to take into account that A has received prior supplemental wage payments during the year in excess of one million dollars from X and Y, because Z is treated as the same employer as X and Y. The income tax required to be withheld on this payment would be 35 percent of $10,000 or $3,500.

Example 2. Employees B and C work for employer M. Each employee receives monthly salaries of $3,000 which are paid on the fifth business day after the end of the month. As a result of the withholding allowances claimed by B, there is no income tax withholding on the regular wages of B paid by M. In contrast, M has withheld income tax from C's regular wages paid by M. Together with the monthly salary check paid on the fifth business day of December, M includes a bonus of $2,000, which is the only supplemental wage payment received by each employee for the calendar year. The bonuses are separately stated on the payroll records of M. M must calculate the income tax withholding required to be made with respect to the bonus paid to B by using the procedure set forth in paragraph (a)(5) of this section. With respect to the bonus paid to C, M has the option of using either the aggregate method provided under paragraph (a)(5) of this section or the optional flat rate provided under paragraph (a)(6) of this section to calculate the income tax withholding due.

Example 3. (i) Employee D works as an employee of Corporation R. Corporations R, S, and T are treated as a single employer under subsection (a) or (b) of section 52. Employee D receives regular wage payments of $200,000 on a monthly basis in 2005 from R and income tax is withheld from those wages. D receives a bonus for his services as an employee from R equal to $3,000,000 on June 30, 2005. Unrelated company U pays D sick pay as an agent of the employer R and such sick pay is supplemental wages pursuant to §31.3401(a)–1(b)(2). D receives sick pay of $50,000 on October 31, 2005. Corporation T decides to award bonuses to all employees of R, S, and T, and pays a bonus of $100,000 to D on December 31, 2005. D received no other payments from U, P, or T.

(ii) In chronological summary, D receives the following wages other than the regular monthly wages paid by R:

June 30, 2005 — $3,000,000 (bonus from R)

October 31, 2005 — $50,000 (sick pay from U)

December 31, 2005 — $100,000 (bonus from T)

(iii) In this *Example 3*, each payment of wages other than the regular monthly wage payments from R is considered to be supplemental wages for purposes of withholding under §31.3402(g)–1(a)(2) because, pursuant to §31.3402(g)–1(a)(3), the payments are treated as made by one employer. The amount of regular wages from R is irrelevant in determining when maximum rate withholding on supplemental wages applies.

(iv) Because income tax has been withheld on the regular wages of the employee, income tax may be withheld on $1,000,000 of the $3,000,000 bonus paid on June 30, 2005, under either paragraph (a)(5) or (6) of this section. If R elects to withhold income tax at the flat rate provided under paragraph (a)(6)(ii)(F), withholding would be calculated at 25 percent of the $1,000,000 portion of the payment, or $250,000.

(v) Income tax withheld on the following supplemental wage payments (or portion of a payment) as follows is required to be calculated at the maximum rate in effect under section 1(c), or 35 percent in 2005 —

(A) $2,000,000 of the $3,000,000 bonus paid by R on June 30, 2005;

(B) $50,000, the sick pay paid on October 31, 2005; and

(C) $100,000, the bonus paid by T on December 31, 2005.

Example 4. (i) Employer J has decided it wants to grant its employee B a $1,000,000 net bonus (after withholding). Employer J has withheld income tax from the regular wages of the employee. B has received no other supplemental wage payments during the year. The mandatory flat rate in effect in the year in which the payment is made is 35 percent, and the optional flat rate in effect is 25 percent.

(ii) This *Example 4* requires grossing up the wage payment to determine the gross wages necessary to result in a net payment of $1,000,000. If the employer elected to use the flat rate applicable to supplemental wages, the first $1,000,000 of the wages would be subject to 25 percent withholding. However, any wages above that would be subject to mandatory 35 percent withholding. The withholding applicable to the first $1,000,000 (*i.e.*, $250,000) would thus be required to be grossed-up at a 35 percent rate to determine the gross wage amount above $1,000,000. Thus, the wages above $1,000,000 would be equal to $250,000 divided by .65 (computed by subtracting .35 from 1) or $384,615.38. Thus the total withholding with respect to the payment if Employer J elected the flat rate with respect to the first $1,000,000, would be $384,615.38 and the total supplemental wage payment, taking into account income tax withholding only (and not Federal Insurance Contributions Act taxes), to B would be $1,384,615.38.

(8) For provisions relating to the treatment of wages that are not subject to paragraph (a)(2) of this section and that are paid other than in cash to retail commission salesmen, see §31.3402(j)–1.

(b) *Special rule where aggregate withholding exemption exceeds wages paid.* (1) This rule applies only if paragraph (a)(2) of this section does not apply to the supplemental wage payment. * * *

(2) The rules prescribed in this paragraph shall, at the election of the employer, be applied in lieu of the rules prescribed in paragraph (a) of this section except that this paragraph shall not be applicable in any case in which the payroll period of the employee is less than one week or if paragraph (a)(2) applies to the supplemental wage payment. * * *

* * * * *

Par. 5. Section 31.3402(j)–1 is amended by adding a new sentence at the beginning of paragraph (a)(2) to read as follows:

§31.3402(j)–1 Remuneration other than in cash for service performed by retail commission salesman.

(a) * * *

(2) Section 3402(j) and this section are not applicable with respect to wages paid to the employee that are subject to withholding under section 31.3402(g)–1(a)(2). * * *

* * * * *

Par. 6. Section 31.3402(n)–1 is revised and the authority citation at the end of the section is removed to read as follows:

§31.3402(n)–1 Employees incurring no income tax liability.

(a) Notwithstanding any other provision of this subpart (except to the extent a payment of wages is subject to withholding under §31.3402(g)–1(a)(2)), an employer shall not deduct and withhold any tax under chapter 24 upon a payment of wages made to an employee after April 30, 1970, if there is in effect with respect to the payment a withholding exemption certificate furnished to the employer by the employee which contains statements that —

(1) The employee incurred no liability for income tax imposed under subtitle A of the Internal Revenue Code for his preceding taxable year; and

(2) The employee anticipates that he will incur no liability for income tax imposed under subtitle A for his current taxable year.

(b) To the extent wages are subject to withholding under §31.3402(g)–1(a)(2), such wages are subject to such income tax withholding regardless of whether a withholding exemption certificate under section 3402(n) and the regulations thereunder has been furnished to the employer.

(c) For purposes of section 3402(n) and this section, an employee is not considered to incur liability for income tax imposed under subtitle A if the amount of such tax is equal to or less than the total amount of credits against such tax which are allowable to him under part iv of subchapter A of chapter 1 of the Internal Revenue Code, other than those allowable under section 31 or 39. For purposes of section 3402(n) and this section, "liability for income tax imposed under subtitle A" shall include liability for a qualified State individual income tax which is treated pursuant to section 6361(a) as if it were imposed by chapter 1 of the Internal Revenue Code. An employee is not considered to incur liability for such a State income tax if the amount of such tax does not exceed the total amount of the credit against such tax which is allowable to him under section 6362(b)(2)(B) or (C) or section 6362(c)(4). For purposes of this section, an employee who files a joint return under section 6013 is considered to incur liability for any tax shown on such return. An employee who is entitled to file a joint return under such section shall not certify that he anticipates that he will incur no liability for income tax imposed by subtitle A for his current taxable year if such statement would not be true in the event that he files a joint return for such year, unless he filed a separate return for his preceding taxable year and anticipates that he will file a separate return for his current taxable year.

(d) For rules relating to invalid withholding exemption certificates, see §31.3402(f)(2)–1(e), and for rules relating to submission to the Internal Revenue Service of withholding exemption certificates claiming a complete exemption from withholding, see §31.3402(f)(2)–1(g).

(e) *Example 1*. Employee A, an unmarried, calendar-year basis taxpayer, files his income tax return for 1970 on April 15, 1971. A has adjusted gross income of $1,200 and is not liable for any tax. He had $180 of income tax withheld during 1970. A anticipates that his gross income for 1971 will be approximately the same amount, and that he will not incur income tax liability for that year. On April 20, 1971, A commences employment and furnishes his employer an exemption certificate stating that he incurred no liability for income tax imposed under subtitle A for 1970, and that he anticipates that he will incur no liability for income tax imposed under subtitle A for 1971. A's employer shall not deduct and withhold on payments of wages made to A on or after April 20, 1971. Under §31.3402(f)(4)–1(c), unless A files a new exemption certificate with his employer, his employer is required to deduct and withhold upon payments of wages to A made on or after May 1, 1972. Under §31.3402(f)(3)–1(b), if A had been employed by his employer prior to April 20, 1971, and had furnished his employer a withholding exemption certificate not containing the statements described in §31.3402(n)–1 prior to furnishing the withholding exemption certificate containing such statements on April 20, 1971, his employer would not be required to give effect to the new certificate with respect to payments of wages made by him prior to July 1, 1971 (the first status determination date which occurs at least 30 days after April 20, 1971). However his employer could, if he chose, make the new certificate effective with respect to any payment of wages made on or after April 20 and before July 1, 1971.

Example 2. Assume the facts are the same as in *Example 1* except that for 1970 A has taxable income of $ 8,000, income tax liability of $1,630, and income tax withheld of $1,700. Although A received a refund of $70 due to income tax withholding of $1,700, he may not state on his exemption certificate that he incurred no liability for income tax imposed by subtitle A for 1970.

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

(Filed by the Office of the Federal Register on January 4, 2005, 8:45 a.m., and published in the issue of the Federal Register for January 5, 2005, 70 F.R. 767)

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2005-2

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Nadler, Herbert	New York, NY	Enrolled Actuary	November 1, 2004 to February 28, 2005

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.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2004–27 through 2004–52 is in Internal Revenue Bulletin 2004–52, dated December 27, 2004.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–27 through 2004–52 is in Internal Revenue Bulletin 2004–52, dated December 27, 2004.

*U.S. G.P.O.: 2005—310–365/70001